Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules.

WC Docket No. 05-________

PETITION FOR FORBEARANCE

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I. INTRODUCTION AND SUMMARY

Pursuant to 47 U.S.C. § 160 and 47 C.F.R. § 1.53, BellSouth Telecommunications, Inc., on behalf of itself and its affiliates ("BST" or "BellSouth"), respectfully requests that the Commission advance the public interest by granting forbearance from its cost assignment rules.[1] When it comes to these rules, the Commission's 2001 diagnosis is correct: "the question is not whether further deregulation should occur, but rather when." Because the Commission's cost assignment rules create a regulatory chokepoint in the development of broadband networks and services, the time for that deregulation is now. As the Commission recognized in the *Wireline Broadband Order*, fundamental changes in the "technology used to build networks, and the

[1] The rules that are the subject of this Petition are Parts 32.23, 32.27, and 64 Subpart I (referred to as "cost allocation rules"); Part 36 (referred to as "jurisdictional separations rules"); Part 69, Subparts D and E (referred to as "cost apportionment rules"); and other related rules that are completely derivative of or dependent on the foregoing rules. Appendix 1 contains a detailed listing of each specific rule from which BST seeks forbearance, which are referred to collectively in this Petition as the Commission's "rate-of-return rules" or "cost assignment rules." The Petition also seeks limited forbearance from 47 U.S.C. § 220(a)(2) to the extent this provision contemplates separate accounting of nonregulated costs. However, BST is not seeking forbearance from the Part 32, Uniform System of Accounts ("USOA" or "Chart of Accounts"), or relevant ARMIS reporting requirements in Part 43 of the Commission's rules.

purposes for which they are built" today are "rapidly breaking down the formerly rigid barriers that separated one network from the other."[2] Yet, the cost assignment rules at issue in this Petition stand in the way of technological innovation, efficiency and competitiveness by maintaining a rigid regulatory barrier between "regulated" and "nonregulated" services that technology and consumers no longer recognize.[3]

The cost assignment rules at issue in this Petition are legacies from decades old rate-of-return regulation that originally applied to AT&T prior to divestiture and, post-divestiture, to the Regional Bell Operating Companies ("RBOCs") as well.[4] This rate-of-return regulatory regime premised rate-setting on carriers' costs and, thus, gave rise to the Commission's cost assignment rules.[5] However, in the mid 1990s the Commission and the nine states that regulate BST abandoned rate-of-return regulation and adopted "price cap" regulation instead. By placing a

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[2] *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, et al.*, CC Docket No. 02-33, *et al.*, Report and Order and Notice of Proposed Rulemaking, FCC 05-150 at ¶ 32 (rel. Sept. 23, 2005) ("*Wireline Broadband Order*").

[3] The Commission has intimated its agreement with this assessment, noting that "the technology used to build networks, and the purposes for which they are built, are fundamentally changing, and will likely continue to do so for the foreseeable future .... *Network platforms therefore will be multi-purpose in nature and more application-based, rather than existing for a single, unitary technologically specific purpose.*" *Id.*, ¶¶ 35-40 (emphasis added).

[4] *See In re: Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, ¶ 26 (1990) ("*Second Report and Order*") ("The basic rate of return mechanisms that form the foundation of our current system of regulation were originally designed for the regulation of public utilities decades ago").

[5] *Id.*, 5 FCC Rcd at ¶ 24 ("... extensive attention is placed on carrier costs. Costs enter the accounting system pursuant to our Part 32 [USOA], and are separated into regulated and nonregulated components in processes dictated under our Part 64 Rules. Regulated costs are then separated into their interstate and intrastate components according to the Part 36 rules. For LECs, interstate regulated costs are then allocated among the access elements we have prescribed in our Part 69 rules."); *see also Wireline Broadband Order*, at ¶ 132 ("The rules ... require LECs to apportion, on an account-by-account basis, all of their costs between regulated and nonregulated activities .... Th[e] level of detail paralleled the level of detail in the cost-of-service calculations that LECs performed to develop their rates for interstate access services").

ceiling on prices, price cap regulation provides more transparency and greater consumer and public protection than did the lengthy and contentious process of attempting to divine the "cost" of service.

Importantly, under price cap regulation, the costs derived from the Commission's cost assignment rules have no bearing on whether rates are "just and reasonable." Nevertheless, BST has remained obligated to allocate costs between "regulated" and "nonregulated" services under Part 64 of the Commission's rules, and to file (and update) a Cost Allocation Manual ("CAM"). Likewise, BST has continued to separate its investment and expenses into intrastate and interstate components in accordance with Part 36 of the Commission's rules, and allocate the interstate investment and expenses in accordance with Part 69 of the Commission's rules. Performance of these tasks has had no connection – and certainly no "strong connection" – to BST's rates for almost ten years. [6]

Similarly, the rules at issue are no longer related to the consumer protection goals for which they were designed, such as protecting ratepayers from bearing risks of carriers' nonregulated activities or preventing cross-subsidization between the regulated carrier and its unregulated affiliates. As the Commission recently acknowledged, price cap regulation has "greatly reduced" the "incumbent LECs' incentives to overstate the costs of their tariffed telecommunications services."[7] When, as here, costs are not part of the ratemaking equation, there is no "incentive" to inflate, misallocate or manipulate costs and, thus, the cost assignment rules are not necessary to protect consumers from that behavior or similar conduct.

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[6] *See Cellular Telecommunications & Internet Association v. FCC*, 330 F.3d 502, 512 (D.C. Cir. 2003) ("necessary," in the context of forbearance, refers to "the existence of a strong connection between what the agency has done by way of regulation and what the agency permissibly sought to achieve with the disputed regulation").

[7] *Wireline Broadband Order,* at ¶ 133.

Nor do the results of the Commission's cost assignment rules guarantee financial transparency or accountability, which are the province of financial accounting rules, the Securities and Exchange Commission ("SEC"), Sarbanes-Oxley and other requirements detailed below. BellSouth will continue to comply with all the financial accounting rules imposed on public companies by the SEC and will continue to be subject to the Uniform System of Accounts in Part 32 and ARMIS reporting requirements in Part 43 of the Commission's rules. Continued compliance with those rules provides ample information about BellSouth's financial condition, should any regulatory agency need that information.

Granting BST's Petition not only is consistent with the public interest, but advances it. Regulatory chokepoints, like the Commission's cost assignment rules, retard the flow of valued, innovative products and services to the marketplace. For every new broadband service that it seeks to offer, BST must conduct an exhaustive analysis of every part of the network and the other resources used to provide the service to ensure compliance with the Commission's cost allocation and affiliate transaction requirements.[8] The more technologically involved the product or service offering, the more allocation decisions are involved: some complex services, in fact, can require up to 100 separate allocation decisions.

These chokepoints are precisely the sorts of regulatory underbrush that cause the U.S. telecommunications industry to lag behind its global competitors and U.S. consumers to lag behind their global neighbors across a broad spectrum of communication products and services.

[8] The example provided in Appendix 5 details 13 separate cost allocation judgments that were required before BST could offer a service consisting of a single platform to monitor and isolate network trouble called the Intelligent Data Service Unit or "IDSU." It took BST three months to devise a plan to comply with the Commission's cost assignment rules in relation to this service. The allocated cost information was used solely to populate a Commission report that served no ratemaking or other legitimate purpose. Ultimately, the customer tired of the wait and took its business elsewhere.

This regulatory handicap is especially inexcusable when, as here, *the regulations no longer bear a connection to the purposes for which they were conceived and implemented.*

Clearing this regulatory blockage is fully consistent with the public interest. There is no good reason that BST's customers should have to wait while BST's products and services stand in a long, value-depleting line of regulatory cost assignment exercises. And, of course, what BST chooses to produce, how it designs and engineers those products and services, and the investments it makes in support of those decisions, should turn on rational engineering and economic judgments, unaffected by the myriad, often bizarre and routinely uneconomic decisions occasioned by outmoded cost assignment rules. It is time for a better approach.

The Commission recognized as much four years ago when it embraced the elimination of outdated and unnecessary accounting rules. In its *2000 Biennial Regulatory Review*, the Commission affirmed its commitment to preserving only those accounting rules that advance a "valid regulatory interest":

> We read section 11 [of the Communications Act of 1934] to require a review of our regulations with an eye toward achieving Congress's goal, in the 1996 Act, of a truly 'pro-competitive, deregulatory' national policy framework for the telecommunications industry. *We recognize that any unnecessary regulation places a corresponding, unnecessary burden on the carriers that are subject to it.*
>
> . . .
>
> Under the direction of the 1996 Act, we are moving to an environment in which *competition will be the main force that sets rates.* Thus, we come to our statutory task with the approach that we will not retain a particular regulation *unless it advances a valid regulatory interest.*[9]

[9] *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, CC Docket Nos. 00-199, 97-212, 80-286 & 99-301, *Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286; Further Notice of Proposed Rulemaking in CC*

Such statements underscore the Commission's recognition that, when the rationale for its accounting rules has been displaced, those rules can harm the very policy goals that the Commission has set today to promote competition.

The Commission acknowledged that its "accounting and cost allocation rules [needed] to be streamlined" when it began a "broad and comprehensive review of its accounting and reporting requirements."[10] This review initially was a two-phase project, with the first phase focusing on accounting and reporting requirements that could be eliminated or streamlined to provide immediate relief, while Phase Two focused on long-term changes.[11] As part of Phase One, the Commission streamlined affiliate transactions rules, eliminated certain Part 32 accounts, and limited certain ARMIS reporting requirements.[12] The Commission made additional modifications in the *Phase 2 Order*. The streamlined processes have now been in place for

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Docket Nos. 00-199, 99-301, and 80-286, 16 FCC Rcd 19,911 at 19,913 (2001) (emphasis added) (internal citation omitted) ("*Phase 2 Order*" or "*2000 Biennial Regulatory Review*").

[10] *1998 Biennial Regulatory Review – Review of Accounting and Cost Allocation Requirements; United States Telephone Association Petition for Rulemaking; Implementation of the Telecommunications Act of 1996; Accounting Safeguards under the Telecommunications Act of 1996; Petition for Forbearance of the Independent Telephone & Telecommunications Alliance; Petition for Rulemaking to Amend Part 32 of the Commission's Rules, Uniform System of Accounts for Class A and Class B Telephone Companies, to Adopt the Accounting for Software Required by Statement of Position 98-1*, CC Docket Nos. 98-81 & 96-150; ASD File No. 98-64; AAD File No. 98-43; RM-9341, *Report and Order in CC Docket No. 98-81, Order on Reconsideration in CC Docket No. 96-150, Fourth Memorandum Opinion and Order in AAD File No. 98-43*, 14 FCC Rcd 11396, 11399, ¶ 6 (1999) ("*Phase 1 Order*"). The Commission began its accounting review pursuant to its obligations under 47 U.S.C. § 161.

[11] *Id.* at 11399-00, ¶ 6.

[12] *See Phase 2 Order.*

several years, and there has been no negative impact on the public or the ability of regulators to fulfill their statutory duties.[13]

Indeed, in 2001, the Commission conceded that "[m]any of the regulations that we review ... survive from the time of the government-sanctioned monopoly provider, when the Commission's main function was rate regulation, which required extensive accounting and reporting information."[14] Furthermore, according to the Commission, "... the question is not whether further [accounting and reporting] deregulation should occur, but rather when."[15]

BST submits that the time for relief from the Commission's cost assignment rules is *now*. BST's Petition provides granular proof that: (1) the Commission's cost assignment rules have no usefulness, either for ensuring the justness and reasonableness of BST's rates or for protecting consumers; and (2) continued compliance and enforcement would be contrary to the public interest by usurping significant BST resources that could be deployed for activities that produce consumer benefit and by diminishing BST's ability to compete effectively in today's rapidly evolving broadband and IP environment.

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[13] The Commission has initiated a Phase Three review, noting that "as regulatory, technological, and market conditions continue to change, the Commission must consider more drastic changes to existing accounting and reporting requirements." *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2 and Phase 3*, CC Docket No. 00-199, *Notice of Proposed Rulemaking*, 15 FCC Rcd 20568, 20601, ¶ 87 (2000). The comment cycle has completed, but no order has been issued.

[14] *Phase 2 Order* at 19913, ¶ 3.

[15] *Id.* at 19985, ¶ 206. After release of the *Phase 2 Order*, which provided streamlining of certain accounting rules, the Commission implemented a Federal-State Joint Conference on Accounting Issues (Joint Conference). The Joint Conference raised "concerns" about some of the streamlining from the *Phase 2 Order,* and accounting deregulation in general. The Joint Conference's concerns, as discussed more fully below, are misguided and do not prevent the Commission's granting of this Petition.

The Commission can no longer ignore the regulatory changes that have occurred in ratemaking policy, the competitive reality of the marketplace the Commission seeks to safeguard, and the increasingly integrated networks and services that technology and IP have enabled.[16] Consistent with its recognition that the regulatory focus has changed and because the rules in question no longer serve any legitimate purpose for a price cap carrier like BST, the Commission should continue on the path toward "accounting and reporting deregulation." The next step on that path should be the Commission's granting of BST's Petition for Forbearance.

II. LEGAL STANDARDS FOR FORBEARANCE

This Petition must be granted if the "three prongs" of the forbearance statute, 47 U.S.C. § 160 (a), are satisfied:

> the statutory test for forbearance under [Section 160 (a)] has three prongs that must all be satisfied before the Commission is *obligated* to forbear from enforcing a regulation or a statutory provision: (1) 'enforcement . . . is not necessary to ensure that the charges . . . are just and reasonable and are not unjustly or unreasonably discriminatory'; (2) 'enforcement . . . is not necessary for the protection of consumers'; and (3) 'forbearance . . . is consistent with the public interest.'[17]

Thus, for purposes of this Petition, if it is shown that the rules at issue are not necessary for ratemaking and are not necessary for protecting consumers, and, that granting forbearance is consistent with the public interest, the Commission *must* grant forbearance.

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[16] *See In the Matter of Petition for Waiver of Pricing Flexibility Rules for Fast Packet Services, Petition for Forbearance Under 47 U.S.C. Section 160(c) from Pricing Flexibility Rules for Fast Packet Services*, WC Docket No. 04-246, *Memorandum Opinion and Order* at ¶ 15 (October 14, 2005) ("The price cap system, adopted in 1990, was designed to replicate some of the efficiency incentives present in competitive markets and to act as a transitional regulatory mechanism en route to full competition.")

[17] *CTIA*, 330 F.3d at 509 (emphasis added). *See In the Matter of Petition for Forbearance from E911 Accuracy Standards Imposed on Tier III Carriers for Locating Wireless Subscribers Under Rule Section 20.18 (H), Order*, WT Docket No. 02-377, 18 F.C.C. Rcd 24648, 24653 (2003).

The D.C. Circuit, in accord with this Commission, has observed that the term "necessary" as used in the forbearance context (as opposed to its other statutory uses in the Communications Act), does not mean "absolutely required."[18] However, in the context of forbearance, regulatory requirements should not be deemed "necessary" unless there is a "*strong connection* between what the [Commission] has done by way of regulation and what the agency *permissibly sought to achieve* with the disputed regulation."[19]

What must be sought in the Commission's review of this Petition, then, is affirmative and dynamic, and not merely passive or neutral. Is the enforcement of the rules -- today and going forward – "strongly connected" to what the Commission "permissibly sought to achieve" with the rules when it implemented them? Put differently, the issue is whether continued enforcement *positively* achieves the Commission's permissible regulatory aims in implementing them; if so, then the rule is "strongly connected." If the rules do not achieve the "permissible" regulatory aims, or if the aims no longer exist, no "strong connection" exists. And, of course, when continued enforcement actually produces *negative* results, then an entirely impermissible *negative* "connection" is revealed. In either case, consistent with the public interest, forbearance must be granted.

Thus, BST's Petition cannot be overcome by claims that the rules are vaguely beneficial, or that the rules are "not unhelpful" to those ends, or that the rules are helpful to some broader array of evolving goals whose connections to the rules' original purposes are weak or remote. A "strong connection" to just, reasonable and nondiscriminatory BST rates, and to the protection of

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[18] *See CTIA,* 330 F.3d at 509-10; *Petition for Forbearance from E911 Accuracy Standards*, 18 FCC Rcd at 24644.

[19] *CTIA,* 330 F.3d at 512 (emphases added). *See also Petition for Forbearance from E911 Accuracy Standards*, 18 FCC Rcd at 24644 ("... in this context, a requirement is 'necessary' for the protection of consumers if there is a strong connection between the requirement and the goal of consumer protection").

consumers, must be shown for continued application of the rules. As demonstrated below, no such connection exists.

III. REGULATORY BACKGROUND

As demonstrated in greater detail below, the cost assignment rules at issue in this Petition are no longer connected (and certainly not "strongly connected") to the legitimate statutory purposes of ensuring that BST provides service at just and reasonable, nondiscriminatory rates. To appreciate this position fully, it is important to understand: (1) rate-of-return regulation and the role of cost assignment rules in establishing rates under this regulatory scheme; (2) price cap regulation, under which rates are regulated without regard to costs; and (3) that BST is no longer subject to rate-of-return in any jurisdiction. Against this regulatory backdrop, the merits of BST's Petition become self-evident.

A. Ratemaking Under Rate-Of-Return Regulation

1. How rate-of-return regulation worked

For decades, federal and state commissions regulated the local and long distance rates charged by AT&T and the RBOCs pursuant to rate-of-return regulation. Rate-of-return regulation emanated from the legal principle, established nearly 80 years ago, that regulators were required to allow carriers to charge rates, which, on a prospective basis, would provide an opportunity for carriers to earn a fair return on their property dedicated to public use.[20] The legal principle developed in an era when communications "property dedicated to public use" meant use for only "plain old [regulated] telephone service" provided over analog networks by monopoly providers.

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[20] *See Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Hope Natural Gas v. West Virginia*, 274 U.S. 284 (1927).

Rate-of-return regulation was a "cost plus" system which required a carrier to determine the amount of investment in its regulated rate base as well as the expenses the carrier incurred to provide services during the year.[21] Detailed tracking of investment and expense was assumed to be, and was, readily accomplished as long as the networks remained single purpose and analog.[22]

The rate-of-return ratemaking process began with the regulatory agency's establishment of a test period. The test period concept was devised to determine the revenue and expenses that would be *representative* of the rate-effective period. For interstate ratemaking purposes, the Commission's test period was usually a prospective 12-month period, that is, the test period projected revenue and expenses for the immediate 12-month future.[23]

Once the test period was determined, the revenues and expenses for that period were estimated. This was a two-step process. The first step was to determine the projected regulated rate base. The rate base was the carrier's assets that were "used and useful" for providing services and typically included, but was not limited to, the telephone plant held in service, plant in construction, and material and supplies. These amounts would be reduced by accumulated depreciation on the plant and various other adjustments that the regulatory agency required to be backed out of the rate base.[24] Once determined, the rate base was multiplied by the authorized

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[21] *Second Report and Order*, 5 FCC Rcd at 6787 ¶ 1 ("[LECs], in providing the critical telecommunications link between a customer's premises and the interexchange networks, have until now been regulated under a "cost-plus" system . . . in which rates . . . are based on costs plus a return on invested capital.")

[22] The task became more arduous as new technology and deregulatory policies introduced multi-use facilities, a development that has reached a crescendo in today's environment of broadband and IP networks.

[23] *See e.g.*, 47 C.F.R. 61.38(b)(1)(ii).

[24] *See* 47 C.F.R. 65, subpart G, for a description of allowable and disallowable assets a rate of return carrier uses to establish its federal rate base.

rate of return[25] to calculate the return on investment that the carrier would be allowed to achieve for the period.

The next step was to project the operating expenses for the test period. Examples of projected expenses included, but were not limited to, plant specific, plant non-specific, customer operations, corporate expenses, operating taxes, and depreciation. The total operating expenses were then added to the return on investment calculated above to determine the "revenue requirement" for the test period. The revenue requirement was allocated over the types of services in order to establish rates for those services for the upcoming year.

The following example helps illustrate the concept of interstate rate-of-return ratemaking:

Revenue Requirement Calculation
Additions:

Telephone plant in Service	11,000
Plant under Construction	1,000
Materials and Supplies	1,000
Total Additions	13,000

Deductions:

Accumulated depreciation	2,000
Accumulated Deferred Fed. Income Tax	500
Customer Deposit	500
Total Deductions	(3,000)
Regulated Rate Base	10,000

Regulated Rate Base	10,000
Authorized Rate of Return	11%
ROI Component of Revenue Requirement	1,100

Operating Expenses:

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[25] The authorized rate of return is established by various methods sanctioned by the regulatory agency.

	Plant Specific	2,000
	Plant Non-Specific	500
	Customer Operations	1,500
	Corporate Operations	100
	Sub Total	4,100
Depreciation		1,900
		6,000
Income Tax		400
	Total Regulated Expenses	6,400
Total Projected Revenue Requirement For Period (Regulated Expenses + ROI Component)		7,500

Thus, pursuant to these calculations, the carrier would price its service(s) in order to achieve revenue of $7,500 for the upcoming year.

Under rate-of-return ratemaking, regulators used actual regulated costs to monitor a carrier's performance. That is, at the end of the year, a carrier's realized rate-of-return was computed from the actual regulated revenue, investment, and expense amounts for that year. To the extent a carrier realized a rate-of-return in excess of approved levels, the carrier might be required to reduce its rates for the next year by the amount of the over-earning.[26]

Continuing the above example, at the end of the year, if the carrier's actual financial results showed that the carrier had earned a net operating income of $1,400 with an actual regulated rate base of $10,000, the actual rate-of-return would be 14% (1,400/10,000), 3% above the authorized rate. If the regulatory agency required excess earnings to be returned to customers, the carrier would have to adjust its revenue requirement, and its rates, downward the

[26] Under the Commission's rules, a carrier's realized rate-of-return was measured over a two-year period. At the conclusion of the two-year period, if a carrier exceeded the maximum allowable rate-of-return, the carrier had to refund the excess return by lowering rates. *See* 47 C.F.R. § 65.701.

next year to reflect the over-earning in the current year. Conversely, if actual financial results showed a net operating income of $1,100 with a rate base of $10,000, the carrier would have achieved the hypothetically authorized rate of 11% and no adjustment would be necessary.

2. Cost data is necessary under rate-of-return regulation

The explanation of rate-of-return regulation, above, underscores the need for access to accurate historical cost data under this traditional form of regulation. Actual financial results reflecting increases or decreases in historical costs factored directly into the determination of whether rates would be adjusted upward or downward in any given rate cycle. Thus, the Commission – through a gradually evolving regulatory process – wanted to ensure that costs were meticulously monitored and assigned. The cost assignment rules (for which BST now seeks forbearance) served that purpose.

In order for this traditional ratemaking process to be properly monitored at the federal level, the Commission established the USOA. The USOA, first codified in Part 31 but now found in Part 32, established the Chart of Accounts that each company subject to the rules must follow and defined the types of revenue, investment, and expenses that could be recorded in each Commission-prescribed account. Under rate-of-return regulation, these accounts are the starting point for all FCC accounting rules and formed the basis for determining the actual regulated rate base and operating expenses for the year.

Additionally, because the telephone company networks and resources were used to provide both interstate and intrastate services, the Commission developed rules (Part 36 – Separations) to separate investment and expenses into the federal and state jurisdictions. The separations process ensured that the costs flowing into the interstate rate-of-return process were only those costs "used and useful" for providing interstate services. The separations process also was important for state ratemaking purposes, which was uniformly operating under rate-of-return regulation at the time.

Through the *Computer Inquiry* line of cases,[27] the Commission eventually permitted AT&T and the RBOCs to provide "enhanced" or "information" services and determined that, since such services were competitive, they should be treated as "nonregulated." While initially offered only through structurally separate affiliates, these services were subsequently allowed by the Commission to be provided on an integrated basis.[28]

[27] *Regulatory & Policy Problems Presented by the Interdependence of Computer & Communications Services & Facilities*, 28 FCC2d 291 (1970); 28 FCC2d 267 (1971), *aff'd in part sub nom. GTE Service Corp. v. FCC*, 474 F.2d 724 (2d Cir. 1973), *decision on remand*, 40 FCC2d 293 (1973). *Amendment of Section 64.702 of the Commission's Rules and Regulations*, 77 FCC2d 384 (1980), *recon.*, 84 FCC2d 50 (1980), *further recon.*, 88 FCC2d 512 (1981), *affirmed sub nom., Computer and Communications Industry Ass'n v. FCC*, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983); *Amendment of Section 64.702 of the Commission's Rules and Regulations*, CC Docket No. 85-229, Phase I, 104 FCC2d 958 (1986), *recon.*, 2 FCC Rcd 3035 (1987), *further recon.*, 3 FCC Rcd 1135 (1988), *second further recon.*, 4 FCC Rcd 5927 (1989), (*Computer III Phase I Order and Computer III Phase I Reconsideration Order vacated California v. FCC*, 905 F.2d 1217 (9th Cir. 1990)); Phase II, 2 FCC Rcd 3072 (1987), *recon.*, 3 FCC Rcd 1150 (1988), *further recon.*, 4 FCC Rcd 5927 (1989) (*Computer III Phase II Order vacated California I*, 905 F.2d 1217 (9th Cir. 1990)); *Computer III Remand Proceeding*, 5 FCC Rcd 7719 (1990), *recon.*, 7 FCC Rcd 909 (1992), *pets. for review denied, California v. FCC*, 4 F.3d 1505 (9th Cir. 1993); *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards*, 6 FCC Rcd 7571 (1991), *BOC Safeguards Order vacated in part and remanded, California v. FCC*, 39 F.3d 919 (9th Cir. 1994), *cert. denied*, 514 U.S. 1050 (1995). *See also Bell Operating Companies' Joint Petition for Waiver of Computer II Rules*, 10 FCC Rcd 1724 (1995); *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services*, 10 FCC Rcd 8360 (1995); *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Review – Review of Computer III and ONA Safeguards and Requirements*, CC Docket Nos. 95-20, 98-10; *Further Notice of Proposed Rulemaking, Report and Order*, 13 FCC Rcd 6040 (1998), *Report and Order*, 14 FCC Rcd 4289 (1999), *on reconsideration*, Order, 14 FCC Rcd 21628 (1999).

[28] *See generally In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, 11 FCC Rcd 17539 at 17542-43 (1996) ("*Accounting Safeguards Order*").

The Commission determined, however, that under rate-of-return regulation, costs associated with these integrated nonregulated services should not be borne by regulated ratepayers. Accordingly, the Commission developed a means for companies to allocate costs between regulated and nonregulated operations in the *Joint Cost Order*.[29]

The *Joint Cost Order* established the Part 64 cost allocation rules as an overlay on the Part 32 USOA. All costs were still recorded in the prescribed USOA accounts. But, because carriers were only allowed to use regulated costs for ratemaking purposes, costs had to be allocated between regulated and nonregulated activities before flowing into the separations process and onto the rate-of-return process (either federal or state).

These cost assignment rules, now codified in Parts 32, 64, 36 and 69, established a "four-step regulatory process that began with an ILEC's accounting system and ended with the establishment of rates for the ILEC's interstate and intrastate regulated services" as follows:

> First, carriers record their costs, including investments and expenses, into various accounts in accordance with the . . . USOA . . . . Second, carriers assign the costs in these accounts to regulated and nonregulated activities in accordance with Part 64 of the Commission's rules to ensure that the costs of non-regulated activities will not be recovered in regulated interstate service rates. Third, carriers separate the regulated costs between the intrastate and interstate jurisdictions in accordance with the Commission's Part 36 separations rules. Finally, carriers apportion the interstate regulated costs among the interexchange services and rate elements that form the cost basis for their interstate access tariffs. Carriers perform this apportionment in accordance with Part 69 of the Commission's rules. The intrastate costs that result from application of the Part 36 rules form the foundation for determining carriers' intrastate rate base, expenses, and taxes.[30]

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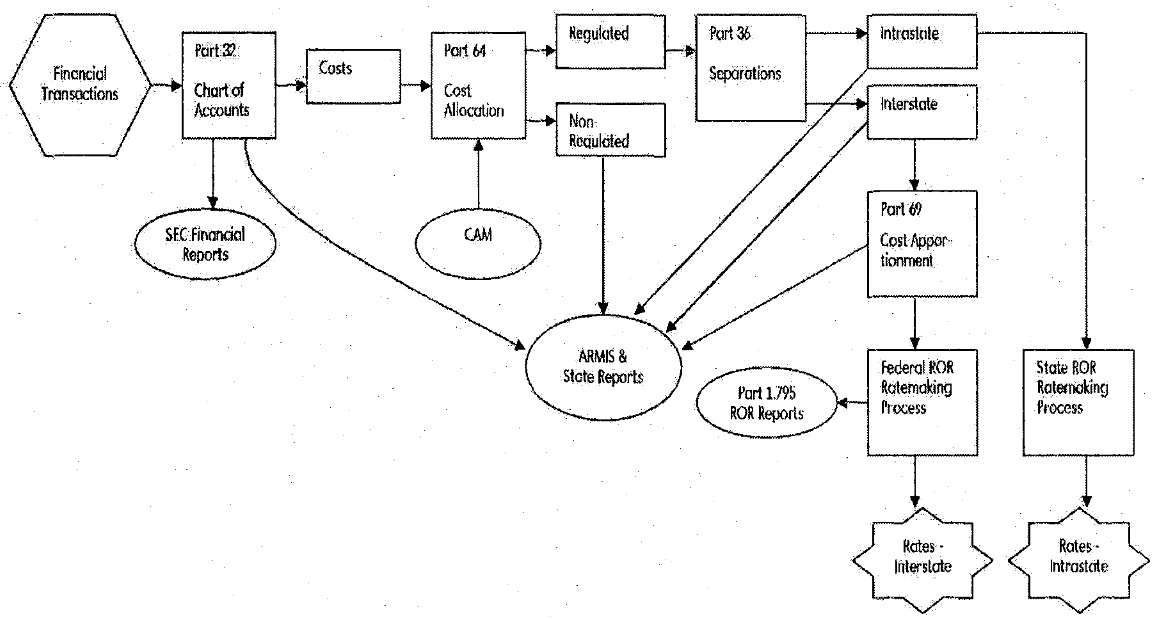
[29] *See Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order*, CC Docket No. 86-111, 2 FCC Rcd 1298, 1330-31 ("*Joint Cost Order*") (1987).

[30] *See Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11382, 11384-85, ¶ 3 (2001), adopting *Recommended Decision*, 15 FCC Rcd 13,160 (2000).

As the Commission states, and as Chart 1 clearly illustrates, the culmination of the cost allocation process under rate-of-return regulation was "the establishment of rates."

1. Cost and Ratemaking Under Rate-of-Return

Under Rate-of-Return, results of cost assignment rules flowed directly into rates.



B. Establishing Prices under Price Cap Regulation.

1. How price cap regulation works

BST has been under totally "pure" price cap regulation at the federal level since 2000.[31] Therefore BST's federally regulated access prices are governed today by the Commission's price cap rules contained in Part 61. Under price cap regulation, an ILEC's prices cannot exceed certain prescribed limits; its costs are irrelevant. For price cap ILECs, price changes are limited by the price cap formula, which incorporates changes in inflation and other non-accounting factors, such as demand changes. These relationships are depicted in the federal price cap formula:

> New year Price Cap Index ("PCI") = Last year's Price Cap [(Inflation - Productivity Adjustment) +/- Exogenous Cost Factor].[32]

Under the FCC's rules, the PCI is currently calculated each year using the Gross Domestic Product Price Index ("GDP-PI") for inflation and a pre-established productivity factor ("X Factor").[33] The PCI also is affected by exogenous changes (costs outside the carrier's control such as new legislation or regulation), which are discussed in more detail below.

The Commission has established a set of baskets for grouping various types of services. These baskets are "broad groupings of LEC services, each of which is subject to its own cap."[34] Multiple service offerings can reside in a given basket. Carriers compare the historic demand multiplied by prospective rates to the revenue cap. Companies can change their tariff rates as

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[31] "Pure" price cap regulation means that the carrier is not subject to a "sharing" component to manage over-earnings or allowed to file a lower formula adjustment for under-earnings. BST was the first ILEC to operate under "pure" price cap regulation when it gave up the lower formula adjustment mechanism ("LFAM") option after being granted pricing flexibility in December 2000.

[32] *See Second Report and Order*, 5 FCC Rcd at 6786.

[33] *See* 47 C.F.R. § 61.45 (a) and (b).

[34] *Second Report and Order,* 5 FCC Rcd at ¶ 11.

market conditions warrant (raise the price of some services, lower the price of others) so long as the total of all services within a given basket are within an acceptable price cap range as defined by Commission rules.[35] Lowering of tariff rates only becomes mandatory when the total of all services in that basket exceeds the price cap.

Finally, ILECs also must calculate Service Band Indices ("SBI") for each category of service within a basket. These pricing bands "permit prices for service categories to increase on a streamlined basis no more than plus or minus 5 percent per year, adjusted for the change in the price cap."[36] Thus, in order for any tariff filing to be deemed "reasonable," the SBI for any service cannot exceed five percent above or below the previous SBI for that service. The API and the SBI were implemented to protect against cross-subsidization between the various baskets of price cap services as well as those services not in price caps.[37] Neither SBI nor API contains any carrier cost element.

Below is an example of how the price cap process works for BST today for a representative price cap basket (*e.g.*, common-line, traffic-sensitive, special access, *etc.*):[38]

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[35] BST must calculate an Actual Price Index ("API") for each basket, which is an index of the level of aggregate rate element rates within the basket. The API cannot exceed the PCI for any basket. There is no carrier cost element in the API determination.

[36] *Second Report and Order,* 5 FCC Rcd *at* ¶ 11.

[37] *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA,* CC Docket Nos. 96-262, 94-1 & 98-157, CCB/CPD File No. 98-63, *Fifth Report and Order and Notice of Proposed Rulemaking*, 14 FCC Rcd 14221, 14251 n.144 (1999) ("*Pricing Flexibility Order*") ("[T]he service band indices (SBIs) were designed to limit cross-subsidization between different types of services within a basket ...").

[38] This example assumes pure price cap regulation under which the carrier is not subject to a "sharing" component or allowed to file a lower formula adjustment for below cap earnings.

Price Cap Calculations:

Adjustment to Price Cap Index (PCI)

Current PCI	50.0000
Gross Domestic Product Price Index	3.00%
GDPPI – X	-3.50%
Exogenous Factor[39]	0.00%
Proposed PCI	48.2500

Impact to Basket Revenue

Basket Revenue at Current PCI	$2,000
Current PCI	50.0000
Proposed PCI	48.2500
Proposed Revenue at Proposed PCI	$1,930

In the foregoing hypothetical price cap basket, the prices for multiple services in the basket will be set in order to generate revenues of $1,930.

2. Cost data is unnecessary under price regulation.

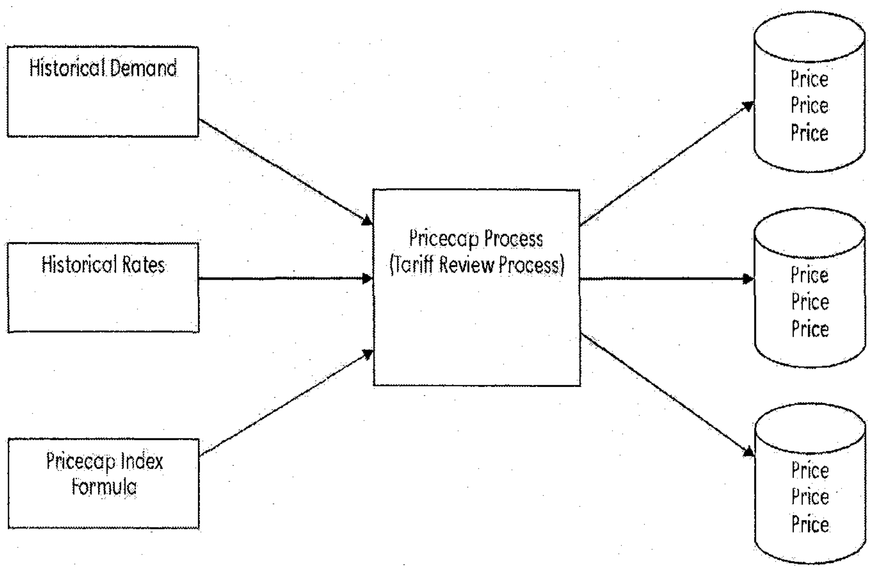
As the above example and Chart 2 clearly illustrate, the inputs into the price cap process do not rely on the results of the cost assignment rules. Unlike the rate-of-return example, when a LEC's costs, and specifically the results of the cost assignment rules, are a critical input that has a direct and meaningful impact on the rates that customers pay, the inputs into the price cap process are governed by economic factors such as productivity and demand. The significant policy realignment from rate-of-return regulation to price cap regulation at both the federal and state levels effectively severed the direct link that was inherent in rate-of-return regulation between carriers' costs and prices for services. In fact, a price cap LEC benefits by keeping

[39] The Exogenous Factor represents costs outside the carrier's control. The Factor can be either a plus or a minus; for example, changes in tax laws could trigger an exogenous adjustment. The adjustment is expressed as a factor representing the adjustment amount divided by the current basket revenue.

costs low (and productivity high) so as to maximize its returns. In short, the shift to price cap regulation fundamentally has obviated the need for the Commission's cost assignment rules.

2. Inputs Into Pricecap Regulation

Results of cost assignment rules do not flow into Pricecap process.



C. **Price Regulation in BST States**

Shortly after the Commission's 1990 adoption of price cap regulation, all of the states in BST's region likewise shifted from rate-of-return regimes to price cap regulation. Now, in each of BST's states -- Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina and Tennessee – BST operates under "pure" price cap regulation (*i.e.*, the plans do not contain any lower formula adjustment mechanism or similar rate-of-return-dependent component). These state plans are similar to the price cap plan the Commission adopted for interstate rates described above.[40] Like the Commission's plan, BST's state price regulation plans no longer rely on cost information for ratemaking purposes.[41] In migrating to price

[40] A general, state-by-state price cap discussion involving BST's territory is contained in Appendix 2.

[41] *See, e.g., Petition of South Central Bell Telephone Company to Restructure Its Form of Regulation; All Telephone Companies Operating in Alabama, Generic Hearing on Local Competition; Streamlined Regulation of Interexchange Carrier and Reseller Telecommunications Services; Complaint Filed By AT&T Communications of the South Central States, Inc. Against South Central Bell on April 25, 1995*, Docket Nos. 24499, 24472, 24030 & 24865, *Report and Order*, 1995 Ala. PUC LEXIS 571, at *42 (Sept. 1995) ("With price regulation, prices charged to customers become the financial focus of the Commission, rather than the earnings of LECs"); *Application of BellSouth Telecommunications, Inc. d/b/a South Central Bell Telephone Company to Modify its Method of Regulation*, Case No. 94-121, *Order*, at 9 (Ky. Pub. Serv. Comm'n July 20, 1995) ("The Commission finds that implementing a price cap form of regulation for South Central Bell is appropriate with the safeguards it has included and will provide added incentive for the Company to operate its business efficiently"); *Regulations for Competition in the Local Telecommunications Market, General Order*, 1996 La. PUC LEXIS 7, at *71 (Mar. 15, 1996) ("The Price Plan is based on the ILEC's rates for service rather than its rate of return"); *Order of the Mississippi Public Service Commission Establishing a Docket to Consider Formulating a Properly Structured Price Regulation Plan for South Central Bell*, Docket No. 95-UA-313, *Order*, at 2-3 (Miss. Pub. Serv. Comm'n Oct. 31, 2001) (noting that Mississippi's Price Regulation Evaluation Plan adopted in 1995 "fostered an environment where, through the regulation of prices as opposed to earnings, BellSouth has become more market-driven and customer-focused, which is beneficial to both BellSouth and its customers"); N.C. Gen. Stat. § 62-133.5(a) (2005) (noting that under price regulation in North Carolina, the local exchange company is permitted "to determine and set its own depreciation rates, to rebalance its rates, and to adjust its prices in the aggregate, or to adjust its prices for

regulation, the states also embraced the same consumer interest and pro-competition benefits that the Commission underscored when it abandoned rate-of return regulation.[42]

IV. THE "REALITY" OF COST ASSIGNMENT

The Commission's cost assignment rules played a critical role in setting rates under rate-of-return regulation; they were created precisely to ensure that rates reflected actual costs and thus were "strongly connected" to achieving the goal of "just and reasonable" rates. However, the cost assignment rules no longer play this role for BST which is subject to price cap regulation in both federal and state jurisdictions. Under price caps, the cost assignment rules have no connection to ensuring that BST's rates are "just and reasonable." While BST meticulously complies with all the Commission's cost assignment rules today, ignoring these rules completely would have no impact on BST's prices under price cap regulation.

Chart 3 illustrates the relationship of costs and rates today and makes clear that the price cap process is entirely separate from the flow of data under the cost assignment rules; they do not interconnect anywhere. The end result of the cost assignment rules for BST is not "the establishment of rates," but rather the population of certain ARMIS reports (and various state informational reports), which are not used for ratemaking purposes. Since the results of the cost

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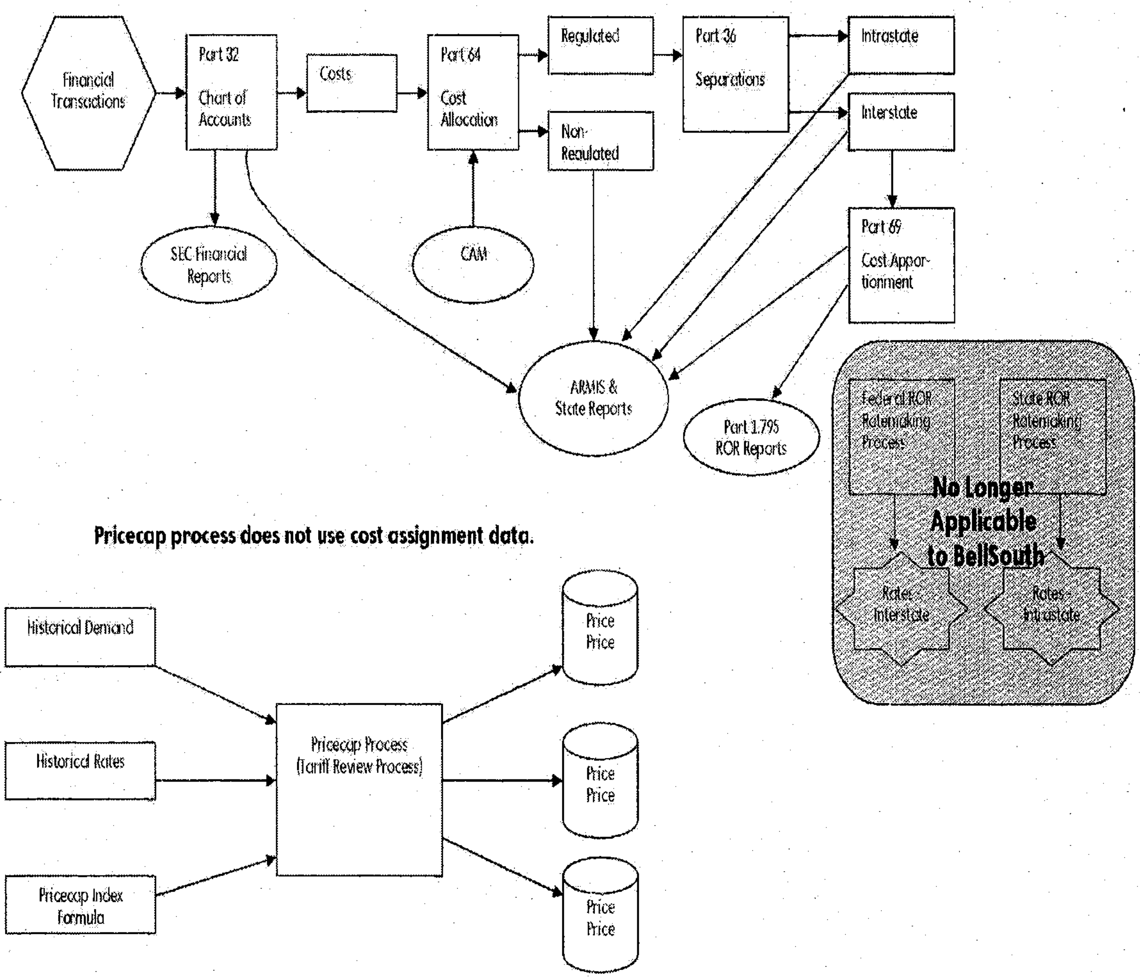
various aggregated categories of services, based upon changes in generally accepted indices of prices").

[42] *See, e.g.,* Ga. Code Ann. § 46-5-161(a)(1) (2005) ("It is in the public interest to establish a new regulatory model for telecommunications services in Georgia to reflect the transition to a reliance on market based competition as the best mechanism for the selection and provision of needed telecommunications services at the most efficient pricing");Tenn. Code Ann. § 65-4-123 (2005) (noting the policy in adopting price regulation in Tennessee "to foster the development of an efficient, technologically advanced, statewide system of telecommunications services by permitting competition in all telecommunications services markets, and by permitting alternative forms of regulation for telecommunications services and telecommunications services providers").

assignment rules are no longer necessary to ensure just and reasonable rates they cannot be shown to have any connection to their original permissible regulatory purpose.

3. Costs and Ratemaking Today

Today, results of cost assignment rules flow only to reports.



Now that it has been established that the cost assignment rules no longer serve their original purpose, one must ask: what is the affect of continuing to require BST to comply with these rules? What is the "reality" of the cost assignment rules today? The answer is that the cost assignment rules create a clear and negative regulatory "chokepoint" that prevents BST from competing fully and effectively in today's broadband/IP/multi-technology platform environment.

Today's customers are demanding innovative services; vendors are rolling out multi-function products; digital packet-based network technologies are offering increased flexibility and capacity. Into this environment, BST is forced to try to shoehorn compliance with cost assignment rules designed for an analog, single purpose, circuit switched network. While its unencumbered competitors can take services directly from the drawing board to their customers, BST must go from the drawing board to a cumbersome cost assignment analysis to determine how to allocate virtually every piece of equipment, every facility, and every human resource that will be involved in the service. A service cannot be offered to a customer until it can be accounted for in compliance with the Commission's cost assignment rules. This process can delay the introduction of new services for as much as six months and in some cases prevents them from getting to market at all.

How can compliance with the cost assignment rules have such a dramatic effect on BST's ability to offer new services and operate efficiently? The following section focuses on one of the primary sets of rules at issue in this Petition and, more importantly, the impact of those rules on day-to-day activities of BST employees and product development teams. A close look at the actual requirements and several examples of the experience of complying with them underscore the "chokepoint" effect of these rules, without the need to delve into the details of the impact of all of the Commission's cost assignment rules.

A. Assignment of Costs to Regulated and Non-regulated Activities (§§ 32.23 and 64.901).

1. The rules

Section 32.23 establishes the basis for allocation of Part 32 investment and expense accounts into regulated and nonregulated activities and describes the accounting treatment of activities classified for accounting purposes as nonregulated. Section 32.23(c) states, in pertinent part:

> When a nonregulated activity does involve the joint or common use of assets and resources in the provision of regulated and nonregulated products and services, carriers shall account for these activities within accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. Carriers shall submit reports identifying regulated and nonregulated amounts in the manner and at the times prescribed by this Commission.[43]

Implementation of Section 32.23 is further codified in Part 64, subpart I. Section 64.901(a) begins the process by requiring BST to "separate [its] regulated costs from nonregulated costs" by using "the attributable cost method of cost allocation." The attributable cost method requires that costs be assigned or allocated on a cost causative basis through a complex hierarchy of allocation factors. This necessitates that BST review each and every service that it offers in order to determine whether it includes a nonregulated component. This review includes underlying operational support.

[43] 47 C.F.R. § 32.23.

If a given service does incorporate a nonregulated component, BST must then follow the allocation process established by the *Joint Cost Order* and codified in Section 64.901(b)(1), which provides as follows:

> (b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.
>
> (1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service. Nontariffed services, offered pursuant to a section 252(e) agreement, provided to a nonregulated activity will be charged to the nonregulated activity at the amount set forth in the applicable interconnection agreement approved by a state commission pursuant to section 252(e) and credited to the regulated revenue account for that service.[44]

Section 64.901(b)(1) requires BST to assign a cost value of a tariffed (*i.e.*, regulated) service used to provide the nonregulated service. Under this rule, when a nonregulated service uses a regulated tariffed service (or a service that is offered pursuant to an interconnection agreement filed with a state commission) the regulated side of the business must charge the nonregulated service the rate established in the tariff (or the interconnection agreement).

Most of BST's nonregulated services are provisioned over network facilities that are not separately identifiable or discretely tariffed. This is particularly true of services which use technologies, such as packet-switching, that are almost impossible to separate and track as the rules require. However, the costs associated with these facilities when used by a nonregulated service must be identified and allocated. This allocation must be done to a minute level of detail to enable the Part 32 accounts containing these costs to be allocated between regulated and nonregulated. Sections 64.901 (b) (2) and (3) establish the allocation process. These rules state:

> (2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

44 47 C.F.R. § 64.901 (b) (1).

> (3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:
>
> > (i) Whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the cost themselves.
> >
> > (ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available.
> >
> > (iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.[45]

To allocate costs to regulated or nonregulated operations in accordance with these rules, BST had to design and develop an extensive cost allocation system to accommodate these requirements. This system must identify all costs that are used exclusively for specific regulated or nonregulated activities, while the remaining costs must be grouped into homogeneous cost categories and then allocated on some basis that best reflects the cost causative nature of the cost. The granularity and methodology of allocation required for Part 32 accounts varies depending on the complexity and the availability of functional cost information.

The structure of allocation methodology, thus, differs for each of more than 100 accounts that are publicly reported via the Commission's ARMIS 43-03. For BST, the allocation of these Part 32 accounts requires the use of approximately 400 cost pools following the analysis required

[45] 47 C.F.R. §§ 64.901 (b) (2) and (3).

by the Commission's Part 64.901 Rules. Before introducing a new service, or modifying an existing service, BST must analyze the costs that are recorded for each Part 32 account and determine the nature of those costs and whether the accounts include costs that are dedicated to or shared between regulated and nonregulated BST operations.

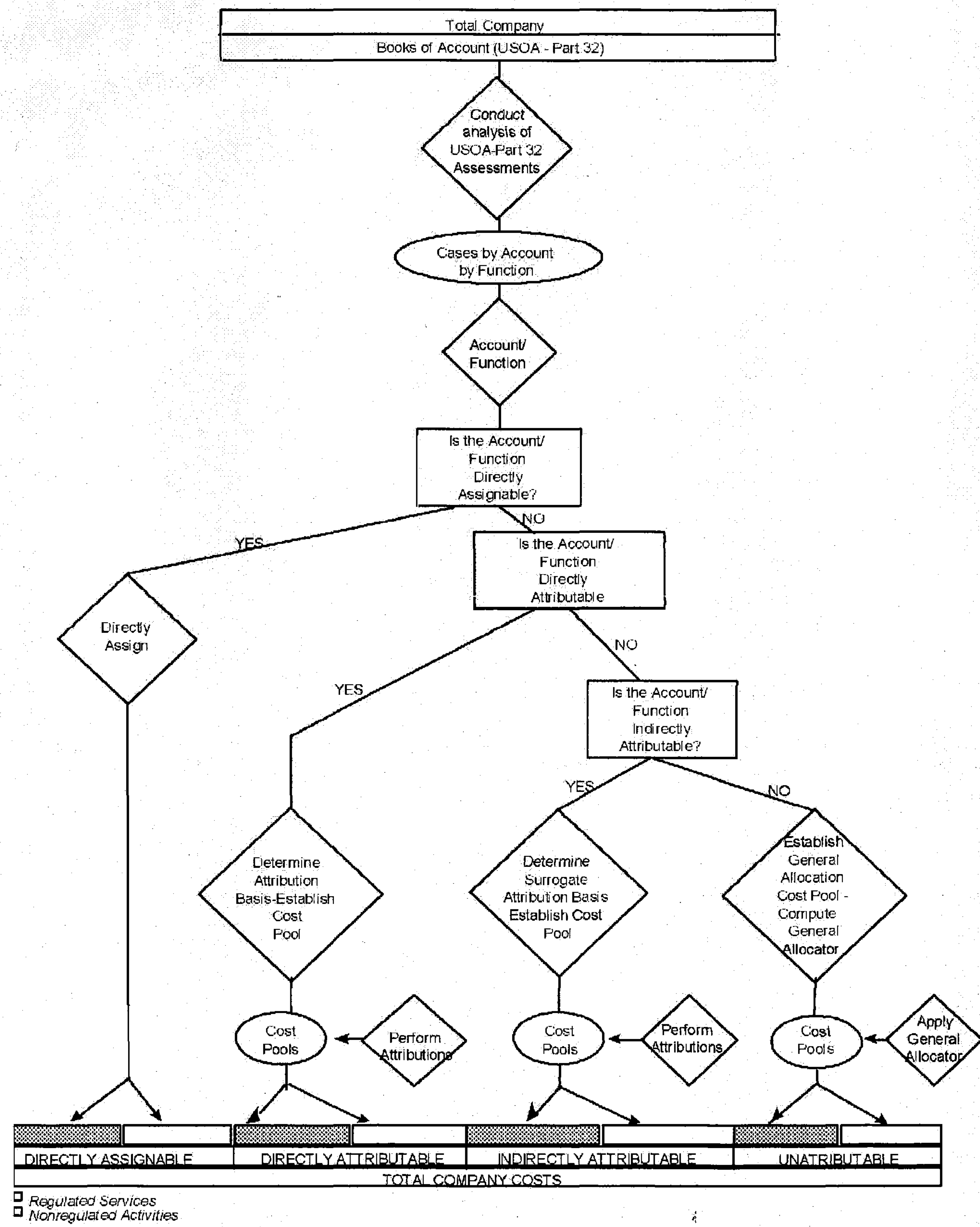
The Commission's Part 64.901 cost apportionment rules require this analysis to be based upon a cost causal relationship which drives the division of cost between four types of cost pools: Directly Assigned, Directly Attributable, Indirectly Attributable, and Unattributable. The rules require direct assignment to the maximum possible extent. Accordingly, every effort is made to find a direct link between regulated or nonregulated operations to be able to Directly Assign costs. When that direct link is absent, BST must make an extensive effort to determine a direct attribution method that closely links the cost to the regulated or nonregulated operations. Special studies and statistical samples are performed in many cases in order to achieve direct attribution.

If direct attribution cannot be achieved for certain costs, BST must research indirect attribution methods. The Commission requires minimal use of the General Allocator or Marketing Allocator in apportioning any Unattributable costs. As a practical matter, this makes the process more involved, but BST makes every effort to avoid the use of that allocator.

Although BST has instituted an extensive array of accounting codes and systems in order to comply with the Part 64.901 hierarchy, new products and services present a challenge to this hierarchy. Thus, each time BST seeks to bring new products and services to consumers, it must first review the existing array of codes to determine applicability. If, as is often the case, the codes do not fit, new apportionment methods and corresponding codes must be developed and implemented. These processes typically take numerous employees several months to accomplish.

The following "Cost Allocation Flow Chart" depicts the processes described above. The chart illustrates how costs flow from their inception through BST's accounting system to allocation into regulated and nonregulated activities. Also attached, as further illustration of these requirements, is Appendix 3, which is one cost apportionment table for accounts 6112-6441 of BST's Part 32 accounts broken down by cost pools and indicating the basis of allocation for the account, *i.e.*, Directly Assigned, Directly Attributed, Indirectly Attributed, or Unattributable.

COST ALLOCATION FLOW CHART



2. **Day-to-Day Operational Impact of Sections 32.23 and 64.901.**

In today's world, engineers design integrated communications networks in order to take advantage of the efficiencies of new technologies. Consumers demand service packages that allow them to reap cost savings and the benefits of innovation. The artificial divisions that legacy cost assignment rules require are not only unrelated to determining rates in a price cap environment, but also represent a formidable obstacle to meeting the demands of the evolving marketplace and giving consumers the innovative products and services they desire. The following examples illustrate the many activities that routinely occur throughout BellSouth in an effort to ensure compliance with these now unnecessary and outdated rules without any corresponding public benefit.

a. **Network assets used in service offerings**

Increasingly, consumers are demanding products and services that entail substantial convergence of regulated and nonregulated network assets (or, in the case of service bundling, convergence of tariffed and non-tariffed services). Whenever a new service is proposed that uses network assets, BST must work extensively to ensure the proper allocation of costs between its regulated and nonregulated books in relation to every aspect of that service. The more complex the network topology, and the more convergence between regulated and nonregulated assets and resources in providing the service, the more cost allocation hurdles there are for BST to jump. If outside vendors provide any of the service elements, of course, then BST must ensure that those vendors develop cost allocation measurements for these elements.

Typically, the result of the rules' application is a morass of regulatory allocation "chokepoints" that BST must navigate before marketing such products or services. This means that specific, interested customers -- or the market more generally -- must wait substantially longer for BST's offerings than would otherwise be necessary if the rules did not apply. Sometimes, customers decline to do so.

The foundation of BST's network of the future is the BellSouth Regional IP Backbone ("BRIB"). To begin the transition today, BST would like to migrate new ATM and Frame Relay customers to the BRIB. Unfortunately, the cost assignment rules get in the way. ATM and Frame Relay services are regulated and the BRIB is unregulated, so they cannot coexist without complying with the allocation rules. Adding to the complexity, these services can involve local and long distance services, which invoke the affiliate transactions rules, which are described more fully below. Identifying relative usage or some other method of allocating and assigning to affiliates costs of equipment shared among these packet-based services is a challenge. The effort and expense in creating some distinction among these packets in order to comply with regulatory cost assignment mandates serve no network purpose and serve only to add complexity and cost.

As computing power increases, network devices such as servers, routers and aggregation hardware that BST is deploying are able to combine traditionally regulated and non-regulated functions. Combining these functionalities offers substantial network operations efficiencies. However, before being able to deploy these devices in the network and take advantage of the more powerful customer features and lower costs they bring, BST must pass such deployment decisions through the chokepoint of the cost assignment rules. Single devices that integrate regulated and non-regulated functions must be split, allocated according to some formula and properly billed to affiliates. Cost allocation software can be written and added to a device CPU to distinguish between regulated and non-regulated uses, but doing so serves no network or consumer functionality.

Cost assignment rules that force engineering focus on separating bits into regulatory buckets instead of on creating more efficient networks and better functionality are not in the public interest. The cost assignment rules create significant complexity around IP-based services such as IPTV and VoIP, for example, as these information services must pass through the cost assignment rules chokepoint before further rollout decisions can be made.

One of BST's recent product development experiences provides a good example of the failure of the rules to deliver for consumers. In 2003, BST began developing a service offering known as Intelligent Data Service Unit ("IDSU") service. In simple terms, IDSU was designed to provide BST's wholesale customers with greater visibility of their networks (*i.e.*, traffic on the customer's local loops). Combined with BST's tariffed frame relay/ATM network management service (which provided network management functionality for traffic within BST's network or "cloud"), IDSU would give the wholesale customer complete, end-to-end information about its network (*i.e.*, from the customer's end user, through BST's cloud and then onward to its destination). By giving the wholesale customer a total picture of its traffic, and not merely the portion within BST's cloud, IDSU would provide that customer much greater ability to monitor and manage the health of its network.

A diagram of IDSU is provided as Appendix 5. The diagram depicts the elements of the IDSU network topology and the points where allocations decisions must be made. These elements and areas include, among other things, a number of processors and servers, several hardware platforms, equipment housing requirements in BST facilities, systems administration and help desk functions, communications links, and various other functions.

The network design and engineering for the IDSU service was certainly challenging, as the diagram suggests. Adding significantly to that challenge, however, was the fact that *a* *separate, detailed cost allocation analysis and decision was required for each and every cost allocable aspect of the service* (thirteen in all). Further, the rules required the *use of different cost allocation methodologies* depending on the nature of the service elements under cost allocation analysis. And, of course, the results of the allocations ultimately served no ratemaking function and provide no customer benefit.

The cost allocation issues that arose in the IDSU project development substantially contributed to several months of delays in finalizing the service for delivery. At the time the allocations process for the IDSU service began, BST had a wholesale customer waiting for the service. The production delay proved costly, however: by the time the allocations processes were completed, the customer had been lost.

b. Advertising

Cost assignment rules greatly complicate even basic tasks like advertising services to potential customers. Because customers are interested in multiple communication services and packages, BellSouth's advertising, like that of its competitors, typically provides consumer information about multiple communications services. Unlike its competitors, prior to placing an ad, BST must attach regulated, nonregulated and affiliate transaction labels to each service mentioned in an ad, and then allocate the costs of the ad according to those labels. Appendix 4 contains several examples of print ads that BST has recently run. BST runs over 2500 different ad pieces every year. A simple decision to include multiple services in a single advertisement brings with it the costs and distractions described below.

In order to allocate the costs of all multi-service print, television, radio and other ads between various services and affiliated companies, BST pays outside vendors and employees to review every line of advertisement text to determine how the advertising costs should be charged its application to affiliates, as required by Part 32.27, or allocated between services, as required by Part 64.901. Take the two page consumer mail ad reproduced at Appendix 4 (pp. 4 and 5). The following services appear in the ad: local service, Complete Choice (a bundle of local service features), DSL, Wireless, Long Distance and Direct TV. One page is reserved for the address and a photo. The question facing the ad agency employee reviewing the ad is how to allocate the costs among all these services. As the Appendix shows, the solution is to read the ad, count the total number of words and then count the number of words associated with each product. The ad has 1,005 words. 621 words are associated with local service, 107 with Complete Choice, 37 with DSL and 13 with wireless service, 43 words are associated with long distance and 184 with Direct TV. White space and common areas are allocated in proportion to the word counts. Radio and television ads are allocated similarly, but instead of counting words, people with stopwatches time the ads and the amount of time spent on each service.

Once the words are counted and the common space allocated, the ad agency prepares an invoice charging the cost of the ad among regulated and non-regulated services and to affiliates such as BellSouth Long Distance. This invoice and the underlying documentation are reviewed for accuracy by a BellSouth advertising manager and by a supervisor. A BellSouth finance employee provides a final review of the allocation and the backup data. The supporting documentation for a single print ad campaign fills a half-inch binder. Finally, an independent auditor, as part of the CAM audit, audits the entire allocation process.

There is no *de minimis* standard: the rules apply regardless of the size of the advertisement or the cost involved, and BellSouth must engage in this exercise for an advertising agency charge as small as $1,000. And, the cost apportionment review described must be performed for the over 2500 different ad pieces that BellSouth produces each year.[46]

c. Time reporting

The cost assignment rules that cause people to count words in print ads and time radio ads with a stopwatch apply just as much to BST's employees as to advertising expenditures. That is, just like ads that contain multiple services, and a network that delivers them, BST (and BellSouth) sales reps, network engineers, science and technology planners and human resources and regulatory employees work on multiple services – some regulated and some not. In order to comply with cost allocation requirements, BST must keep separate track of every employee's regulated and nonregulated activities. Cost allocation touches every employee at BST, and requires every supervisor to review the allocation of employee time between regulated and nonregulated activities, and finance and accounting personnel to calculate the actual cost charges. This is not productive activity.

Appendix 6 illustrates what it means to allocate time among the various buckets created by the cost assignment and affiliate transaction rules. Customer service representatives ("CSRs") can and do provide consumers with information about multiple services over the telephone. Some services are regulated, some are not; some are provided by affiliates, and some not. The cost assignment rules require that CSR time be properly split out and accounted for.

In order to do this, BST employs a statistician to devise a statistically significant CSR time sampling plan. The plan involves a monthly schedule of call center locations to monitor. BST then hires observers to monitor individual CSR calls according to this plan. These observers listen in to customer calls and, with a split stopwatch, time the length of the call and

[46] Appendix 4 contains a flow chart and supporting information depicting this process in more detail.

the amount of time spent on each of the different regulatory buckets. Data is collected and analyzed.

A sample of a CSR time analysis spreadsheet is contained in Appendix 6, p. 2. As displayed in that spreadsheet, this expense and effort yields the information that CSRs spent 4.04% of their time on basic inside wire in Alabama in the period March-May of 2005. CSRs spent 4.53% of their time during that period in Florida on Memory Call, and 18.08% on Internet services.

These data go into cost allocation formulas which are used to allocate CSR time among various services and to charge affiliates. Of course the underlying CSR studies, statistical sampling plan and results are subject to regular audit as part of the CAM audit. The results are only used to populate the ARMIS 43-03 report, but are not used for ratemaking purposes.

d. <u>**Floor space**</u>

A different but no less telling example of the complications caused by the Commission's rules is the allocation of floor space, which is an extraordinary process mandated by the *CAM Uniformity Order*.[47] In that order, the Bureau sought to establish uniform practices among CAM-filing LECs, which included ordering nine specific cost pools and associated methodologies to allocate building costs based on how such buildings are used.

To comply with the *CAM Uniformity Order*, BST must prepare detailed floor space maps for its buildings. These maps, examples of which are attached as Appendix 7, reflect the total floor space and the proportion of such floor space being used by BST and its affiliates. BST

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[47] *Implementation of Further Cost Allocation Uniformity*, AAD 92-42, 8 FCC Rcd 4664, Memorandum Opinion and Order (1993) ("*CAM Uniformity Order*").

must prepare these maps, *down to the square foot,* for the over 33 million square feet of floor space in over 700 office buildings.

After these maps are prepared, BellSouth must monitor all employee moves. When an employee or group of employees moves, BellSouth updates its records monthly to accurately reflect the floor space used by BST and that used by BellSouth affiliates.

Because of the work effort involved in updating these records, which include preparing new floor space maps, every employee move must be approved or denied by a cost allocation oversight group. Not infrequently, a move request is denied simply because the cost of complying with the accounting rules outweighs the efficiency that would otherwise be gained by moving the employee or group of employees.

As required by the Commission, BST must perform an annual study, at its own expense, to verify its floor space records and the resulting allocation of costs. The actual floor space analysis entails, among other things, the hiring of a statistician to perform sampling studies of BellSouth's building space.[48] Typically, 150 buildings are surveyed annually. Completion of the floor space analysis alone generally involves 40 BellSouth managers, who must take time away from their normal real estate management duties, and requires approximately 1500 hours of their time.

[48] *CAM Uniformity Order,* 8 FCC Rcd at 4666-67, ¶¶ 19-22.

B. Other Unnecessary Cost Allocation Rules.[49]

1. Sales of services and asset transfers between BST and its affiliates (§ 32.27).

In addition to the Part 32.23 and Part 64, subpart I, requirements for cost allocation, BST also must comply with Section 32.27 regarding affiliate transactions. Section 32.27 governs how BST must account for assets and services transferred between itself and any of its nonregulated affiliates. The purpose of the rules was to ensure that ILECs did not record the purchase of assets or services from an affiliate at too high a price and then pass that cost on to the ILEC's ratepayers. In addition, the rules were intended to keep an ILEC from recording services or assets sold to an affiliate at suspiciously low prices and subsequently passing on the cost under-recovery to ratepayers. Since adoption of price caps in both federal and state jurisdictions, the costs BST records on its books as a result of these affiliate transaction rules do not "pass through" to any rates and thus no longer serve the intended ratepayer protection role. Today, the results of these rules are solely to populate ARMIS reports.

The rules governing sales of services (32.27(c)) require that every service provided between BST and a nonregulated affiliate[50] must be analyzed individually according to the Commission's three-step hierarchy before the transaction can be recorded. In the first step, if a tariff or interconnection agreement exists for the service then the transaction is recorded at that rate. If no tariff, or equivalent, is available then BST follows the second step and records the

[49] Although the rules discussed below are as vital to this Petition for Forbearance as the others, BST, in the interest of brevity, will confine this discussion more narrowly. BST is fully prepared, of course, to provide detailed examples of rules' applications for each of the scenarios now described.

[50] BST's CAM includes seven pages of descriptions of assets and services provided between BST and its nonregulated affiliates. Examples are office space, procurement, security, training, and insurance support.

services at the prevailing market price (providing such a price can be established only by sales of more than 25% to third parties.)

When neither the first or second step of the hierarchy can be met, BST must move to the third and most complex step. Fully Distributed Cost (FDC) must be established for each of these transactions. This requirement means that, not only BST, but also otherwise nonregulated affiliates must maintain a costing system based upon 64.901 of the Commission's rules in order to ensure BST's compliance with 32.27. Nonregulated affiliates that are designed to provide services only within the corporate family pass this FDC information to BST for the transaction recording.

If the affiliate has services offered to external customers as well as affiliates and the total sales of the services provided to affiliates is less than $500,000 annually, the FDC is provided to BST for the recording of that service. If BST has external sales below the $500,000 benchmark, the service is recorded at FDC. If the affiliate or BST has sales for the service in excess of $500,000, the third step of the hierarchy becomes more complex. For each of these services Estimated Fair Market Value (EFMV) must be compared against FDC.[51] Each EFMV study typically costs more than $100,000 and takes several months to produce. The rules require that such a service transaction from BST to a nonregulated affiliate must be recorded at the higher of EFMV or FDC; a service transaction from an affiliate to BST must be recorded at the lower of EFMV or FDC.

The sole purpose of calculating FDC and paying for an EFMV study is to compare the two values and record the lower or higher value on the books as the cost of the transaction. Regardless of which value is recorded, the cost has no impact on BST's prices set *via* price caps.

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[51] In 2005, BST has 18 services that fall within this category of affiliate transactions.

A very similar process is required for assets transferred between BST and affiliates, except that the comparison is between EFMV and Net Book Costs. Ironically, if BST has to record an asset transfer at EFMV to comply with FCC rules, it must also maintain records for these transfers at Net Book Cost to comply with Generally Accepted Accounting Principles (GAAP). GAAP requires that all public companies transferring assets between affiliated entities record those transactions at Net Book Cost.[52]

2. <u>The "CAM"and independent audit requirements (§§ 32.9000, 64.903 and 64.904).</u>

BST is required to file a Cost Allocation Manual every year in December and whenever there are significant modifications.[53] The CAM, the preparation of which is governed by Section 64.903, must describe how BST separates regulated from non-regulated costs and must contain the following: (1) a description of each of the carrier's non-regulated activities; (2) a list of all incidental activities; (3) a chart showing all corporate affiliates; (4) identification of each affiliate that has transactions with BST and the nature of those transactions; (5) cost apportionment tables for each Part 32 account that contains costs; and (6) a description of all time reporting procedures BST uses. Although these filings are subject to public comment, no third-party has filed comments on BST's CAM or any CAM revision since 1991.

Moreover, pursuant to Section 64.904,[54] BST's CAM is audited for compliance with each of the Part 64, subpart I rules as well as the affiliate transactions rules. BST must hire an outside

[52] FAS 141, paragraph D12. "When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer."

[53] 47 C.F.R. § 32.9000. SBC, Verizon, and Qwest are the other three companies that continue to have a CAM filing obligation.

[54] *See* 47 C.F.R. § 64.904.

auditor at a cost of over $1 million per year to conduct this exhaustive audit.[55] The auditors and BellSouth employees spend several months every year scrutinizing the records to confirm that every cost allocation rule is followed down to its strictest detail. Given that cost allocation rules are no longer "strongly connected" to their original purpose, it is ironic that these are the only FCC rules which are subject to such a rigorous audit requirement.

C. **Jurisdictional Separations (Part 36).**

Jurisdictional separations is "the third step in [the] four-step regulatory process that begins with an ILEC's accounting system and ends with the establishment of rates . . . ."[56] Under the jurisdictional separations process, BST must allocate regulated costs between the intrastate and interstate jurisdictions. The astonishingly detailed methodology developed to undertake this process is on display in the 86 pages of separations rules contained in Appendix 1.

The original purpose of jurisdictional separations was to prevent ILECs from recovering the same costs in both the interstate and intrastate jurisdictions. This concern and, thus, this purpose were only valid under rate-of-return regulation where costs could have a direct impact on rates. For BST, the need for a separations process evaporated when both federal and state regulators moved to pure price cap regulation.

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[55] The independent audit requirement was originally designed to aid the Commission in fulfilling its responsibility to ensure that carriers complied with the Commission's rules. However, the Commission exempted mid-size carriers from performing these independent audits to "significantly lighten regulatory burdens," even though many of these carriers are rate-of-return regulated. *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, CC Docket Nos. 00-199, 97-212, 80-286 & 99-301, *Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286; Further Notice of Proposed Rulemaking in CC Docket Nos. 00-199, 99-301, and 80-286*, 16 FCC Rcd 19911, 19980, ¶ 189 (2001).

[56] *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, supra*, at ¶ 3.

The Commission itself has raised questions about the continued need for separations for price cap carriers,[57] particularly in an era of rapidly changing technology that is blurring formerly clear jurisdictional boundaries between services. As a result, and upon recommendation of the Federal-State Separations Joint Board, the Commission adopted an interim freeze on its jurisdictional separations rules effective July 1, 2001.[58] Specifically, the Commission placed a freeze on Part 36 category relationships and jurisdictional allocation factors for price cap carriers.[59]

In imposing the freeze, the Commission noted the "rapid changes in the telecommunications infrastructure, such as the growth in Internet usage and the increased usage of packet switching," "other new technologies, such as digital subscriber line (DSL) services, as well as a competitive local exchange marketplace." These developments, the Commission properly observed, were "not sufficiently contemplated by the current Part 36 rules."[60]

The Commission concluded that a freeze of the separations process would "reduce

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[57] *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Notice of Proposed Rulemaking*, 12 FCC Rcd 22120, 22140, ¶ 41 (1997).

[58] *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board,* CC Docket No. 80-286, *Recommended Decision*, 15 FCC Rcd 13,160; *Jurisdictional Separations and Referral to the Federal-State Joint Board,* CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11,382 (2001) ("*Separations Freeze Order*").

[59] "Category relationships" are the percentage relationships of each Part 36 category to the total amount recorded in its corresponding Part 32 account(s). *See* 47 C.F.R. Part 32, Part 36. "Jurisdictional allocation factors" are the percentage relationships that allocate costs assigned to Part 32 accounts for jointly used plant between the interstate (federal) and intrastate (state) jurisdictions. *See Id.*

[60] *Id.* The Commission noted that the increased use of packet-switching "may call into question the continued validity of usage-based separations procedures designed for circuit-switched technologies and services." Because packet switching enables a single transmission path to carry packets from many different customers during the same period, while circuit-switching requires a dedicated single transmission path to one customer for the duration of a call, the Commission observed that its "Part 36 rules do not appropriately address the allocation methods for these newer technologies." *Id.*

regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace."[61] Because only ILECs are required under the Part 36 rules to perform separations studies, while CLECs have no similar requirements, the Commission found that a freeze would further its stated goal "of achieving greater competitive neutrality during the transition to a competitive marketplace by simplifying the separations process for those carriers subject to Part 36."[62] The Commission, thus, recognized that continued application of the separations process was inconsistent with a technologically evolving, and increasingly competitive marketplace.

Since the Commission adopted the separations freeze in 2001, the trends that it cited in support of that action have accelerated at a pace more rapid than anyone imagined. Driven by wireless and IP technologies, the telecommunications marketplace is far more competitive today than in 2001 and many more services and service bundles have been deregulated. "Internet usage" has not just grown, it has transformed into a full-fledged roll-out of IP networking technologies, multi-function facilities, and services such as VoIP and IPTV. These were clearly not "sufficiently contemplated" by the Part 36 rules and that fact, combined with today's price cap regulation, demonstrates the appropriateness of granting BST forbearance from the separations rules.

D. Part 69 Interstate Cost Apportionment Rules.

The final step in rate-of-return ratemaking is setting rates across the LEC's services. The purpose of the Part 69 rules was to apportion separated interstate regulated costs among interstate access service categories. The apportioned costs represented the fully distributed costs of the access categories and, prior to price caps, the cost basis upon which interstate access rates were

[61] *Separations Freeze Order,* 16 FCC Rcd 11,382 at ¶ 13.

[62] *Id.*

set. These costs were used to calculate the interstate rate-of-return on the different interstate access categories. With the adoption of price cap regulation, such costs no longer are used for rate-setting. Thus, the cost apportionment rules, like the separations rules from which they extend, are not connected to price cap ratemaking, and, frankly, serve no other legitimate regulatory purpose in BellSouth's case.

V. DISCUSSION

Under 47 U.S.C. § 160, the Commission must grant BST's Petition for Forbearance if it determines that: (1) enforcement or application of the Commission's cost assignment rules are not "necessary to ensure that ... [BST's] charges ... are just and reasonable and are not unjustly or unreasonably discriminatory;" (2) enforcement or application of the rules at issue is not "necessary for the protection of consumers;" and (3) forbearance from the rules' application is "consistent with the public interest."[63] BST's Petition satisfies each of these elements.

A. The Commission's Cost Assignment Rules Are Not Necessary To Ensuring That BST's Rates Are Just, Reasonable, And Nondiscriminatory.

No dispute exists that BST's interstate and intrastate rates are regulated under price cap regulation, rather than rate-of-return regulation. It is equally beyond dispute that the complicated tracking and allocation of investments and costs between regulated and nonregulated activities and the apportionment between interstate and intrastate jurisdictions play no role under price cap regulation in determining whether BST's rates are just, reasonable, and nondiscriminatory at either the federal or state level. BST's compliance with these rules, thus, is not necessary to the Commission's rate-setting goals, and forbearance from continued enforcement must be granted.

[63] *See* 47 U.S.C. §§ 160 (a) and (c).

1. <u>The Commission does not rely on cost assignment data to set BST's prices.</u>

As the Commission itself observed when it adopted price cap regulation, cost calculation is not a part of the price cap paradigm:

> . . . incentive regulation relies in the first instance on regulating *prices*. By establishing limits on prices carriers can charge for their services, and placing downward pressure on those limits or 'caps,' we create a regulatory environment that requires carriers *to become more productive.* Carriers that can substantially increase their productivity can earn and retain profits at reasonable levels above those we allow for rate of return carriers . . . . *If carriers fail to become more productive, they risk seeing their earnings erode.*[64]

Indeed, price caps, by design, impel carriers to police their own costs in order to achieve desirable earnings, and by adopting price cap regulation, the Commission and the states have eliminated the core logic underlying the cost assignment rules.

At the federal level, the price cap regime sets a ceiling on the prices BST may charge for its interstate services. The costs that BST incurs in providing these services have no bearing whatsoever on this price ceiling. Thus, BST's costs have only an income statement effect, identical to any company, in that they only determine profit or loss, which is not germane to price regulation under the Commission's price cap plan. Indeed, because the prices customers pay for interstate services are capped, the only constituency that should be concerned about BST's cost of providing service is BellSouth and its shareholders.

The continued need for the cost assignment rules under price cap regulation repeatedly has been called into question. As the Commission itself noted in *Computer III*, "because price cap regulation severs the direct link between regulated costs and prices, a carrier is not able

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[64] *Second Report and Order, supra*, at ¶ 22.

automatically to recoup misallocated non-regulated costs by raising basic service rates, thus reducing the incentive for the BOCs to shift non-regulated costs to regulated services."[65]

The Commission examined the continued need for its cost assignment rules in light of price cap regulation in 1996.[66] In that proceeding, the Commission found that carriers still had a potential incentive to "assign a disproportionate share of costs to regulated accounts" due to the sharing component of price caps, the lower formula adjustment mechanism ("LFAM"),[67] and the fact that some intrastate services remained under rate-of-return regulation. However, the Commission's findings are no longer applicable to BST.

First, in 1997 the Commission eliminated the sharing component (*i.e.*, the "sharing" of excess earnings with ratepayers) that was included in the original price cap plan. Elimination of the sharing requirement, the Commission observed, "[r]educed reliance on accounting costs," which, according to the Commission, would "facilitate[] our transition to the competitive paradigm of the 1996 Act."[68]

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[65] *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards*, CC Docket No. 90-623, *Report and Order*, 6 FCC Rcd 7571, 7596, ¶ 55 (1991), *vacated in part and remanded, California v. FCC,* 39 F.3d 919 (9th Cir. 1994), *cert denied*, 514 U.S. 1050 (1995); *see also, California v. FCC*, 39 F.3d at 926-27; *United States v. Western Elec. Co.*, 993 F.2d 1572, 1580 (D.C. Circuit), *cert denied*, 510 U.S. 984 (1993) ("[price cap regulation] reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling").

[66] *Accounting Safeguards Order, supra,* 11 FCC Rcd 17539.

[67] The original price cap plan included a mechanism that protected carriers from earning below a prescribed rate of return. If the carrier could demonstrate that its earnings were below the rate of return set in the plan, the carrier could make a below cap filing to increase rates to achieve the prescribed rate. As discussed herein, the LFAM has been eliminated for BST.

[68] *See Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, CC Docket Nos. 94-1 and 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642, 16700, ¶ 152 (1997) ("*1997 Price Cap Review Order*"), *aff'd in part, rev'd in part, United States Telecom Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

Second, as a result of pricing flexibility,[69] the LFAM is no longer applicable to BST, which further erodes any need for retaining the cost assignment rules.[70] Indeed, in eliminating the LFAM for ILECs operating under pricing flexibility, the Commission found that doing so "might enable the Commission to relax, for that LEC, any accounting rules necessitated only by the rate-of-return-based low-end adjustment mechanism."[71]

Third, as discussed previously, BST operates under price regulation in all of its states. Thus, there are no longer any intrastate services offered by BST that remain under rate-of-return regulation, which further eviscerates the need for the Commission's cost assignment rules.

It has been argued in the past that, even with price cap carriers, the cost assignment rules continue to be important to the federal price cap process because they impact the productivity factor and exogenous cost elements used in the price cap formula.[72] This argument is without merit.

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[69] In the *Pricing Flexibility Order*, the Commission granted price cap carriers greater freedom in pricing certain services subject to the carrier demonstrating a sufficient level of competition within the market for those services. *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket Nos. 96-262, 94-1 & 98-157, CCB/CPD File No. 98-63, *Fifth Report and Order and Notice of Proposed Rulemaking*, 14 FCC Rcd 14221, 14251 n.144 (1999) ("*Pricing Flexibility Order*").

[70] The LFAM was eliminated for any price cap ILEC that chose to take advantage of pricing flexibility for access services, which all of the major ILECs have done. *See Pricing Flexibility Order,* 14 FCC Rcd at 14304, ¶162, ("We eliminate the low-end adjustment mechanism for price cap LECs that qualify for and elect to exercise either the Phase I or Phase II pricing flexibility we grant in this Order.").

[71] *Id.* at, 14306-07, ¶ 166.

[72] *See, e.g.*, Letter from Alan Buzacott, Senior Manager, Regulatory Affairs, MCI, to Michelle Carey, Chief, Competition Policy Division, Wireline Competition Bureau, FCC (Feb. 9, 2004), transmitted by letter from Gil M. Strober, Lawler, Metzger & Milkman, LLC, to Marlene Dortch, Secretary, FCC, WC Docket No. 02-112 & CC Docket No. 00-175 (Feb. 9, 2004) ("MCI Letter"); Letter from Michael J. Hunseder, Sidley Austin Brown & Wood, LLP, to

First, the productivity or "X-factor" "measure[s] . . . the amount by which LEC productivity exceeded that of the economy as a whole."[73] In the price cap formula, the productivity factor offset "subtracts the amount by which LECs can be expected to outperform economy-wide productivity gains."[74] This factor is established using a variety of methodologies based on economic inputs that look at the productivity of the domestic economy as a whole, as well as the telecommunications industry. None of these methodologies relies on the cost assignment rules.[75]

Second, by definition, exogenous costs are those "triggered by administrative, legislative, or judicial action *beyond the control of the carriers*."[76] Exogenous changes represent items that would have had an impact on the July 1, 1990 data used to establish the initial price cap rates, but were not reflected in the initial rates. Indeed, two exogenous adjustments noted in the price cap rules would be inapplicable if BST's Petition is granted. The first is cost changes caused by changes in the separations manual, and the other is cost changes caused by the reallocation of investment from regulated to nonregulated activities pursuant to 64.901. The separations manual adjustments were mooted by the implementation of the separations freeze in 2001. And, if BST were no longer required to apply 64.901, then the exogenous adjustment

Marlene H. Dortch, Secretary, FCC, CC Docket No. 02-33 & WC Docket No. 02-112 (Feb. 13, 2004) ("AT&T Letter").

[73] *Price Cap Order*, 5 FCC Rcd at 6796, ¶ 74.

[74] *Id.*

[75] Although economic inputs may include total company costs, those costs are not derived from, or based on, the cost assignment rules. In any event, such total company cost information will remain readily available, should it be needed for valid regulatory purposes.

[76] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, *Order on Reconsideration*, 6 FCC Rcd 2637, 2662, ¶ 58 (1991).

relating to the reallocation of investments from regulated to nonregulated activities would also be rendered moot.

2. **<u>The States[77] do not rely on cost assignment data to set BST's rates.</u>**

At the state level, BST's rates are regulated under price cap plans without regard to the information generated by the Commission's cost assignment rules. Indeed, if the Commission were to grant BST's Petition, the state commissions in BST's region would continue to regulate BST's rates in the same way they have for the past decade.[78]

When a need exists for jurisdictional information for monitoring or other purposes, BST can develop such information to meet those state-specific requirements without continued compliance with the Commission's cost assignment rules. For example, in BST state jurisdictions, intrastate revenues must be identified for the purpose of assessing regulatory fees. BST's Petition does not affect revenue. Revenue can be identified by jurisdiction through the Part 32 accounts, and this Petition does not affect those accounts. The Petition deals only with the assignment of costs (expense and investment). Thus, the Commission's granting of this Petition would not impact BST's ability to provide revenue figures on an interstate or intrastate basis. Although ARMIS reports would only contain total revenues, BST's accounting records contain sufficient detail to enable BST to provide intrastate revenue data to any state public service commission in its territory as needed.

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[77] By including an analysis of state needs and requirements in this discussion, BST does not intend to suggest an expanded view of the Commission's jurisdiction. Indeed, BST assumes that the Commission, as it stated in the *Phase 2 Order and NPRM*, continues to "*believe that, if we cannot identify a federal need for a regulation, we are not justified in maintaining such a requirement at the federal level.*" *Phase 2 Order and NPRM, supra*, 16 FCC Rcd 19,911 at ¶ 207 (emphasis added).

[78] *See* discussion in footnote 45, *supra*, and Appendix 2.

Similarly, all of the states in BST's region require that the price for a new service equal or exceed the long run incremental cost ("LRIC") or the total service long-run incremental cost ("TSLRIC") of such service. However, this requirement has no bearing on the Commission's decision here because none of the cost assignment rules is necessary for the calculation of either LRIC or TSLRIC, both of which measure *forward-looking costs*. The *only* situation in which historical costs factor into a LRIC or TSLRIC calculation is with respect to indirect costs. However, indirect costs are generally determined based on ratios of direct costs, which can be calculated without having to apply the Commission's cost assignment rules.

In three states -- Kentucky, Louisiana, and Mississippi – BST submits income statement detail for regulated or intrastate operations. However, continued compliance with the Commission's cost assignment rules is not necessary for BST to meet these reporting requirements. Certainly, no "strong connection" exists between the cost assignment rules' continued application and these limited regulatory purposes. Rather, BST can provide state-specific data for Kentucky, Louisiana, and Mississippi by performing state-specific studies.[79]

Furthermore, it makes little sense to use federally mandated, region-wide cost data to satisfy state-specific reporting obligations, since such requirements could change. Indeed, since inception of price regulation, the states have steadily streamlined or eliminated financial reporting requirements to reflect the changing regulatory and competitive environment. Forbearance would facilitate BST's ability to meet the needs of individual states as they adopt reporting requirements that are more reflective of the price regulation plans now in place.

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[79] To the extent that any of BST's states requires allocated or separated costs for regulatory purposes, BST can produce the data by performing targeted, state-specific studies to meet any such requirements.

In short, the Commission's cost assignment rules have outlived their usefulness. By regulating rates without regard to BST's costs, the current price cap regime at both the federal and state level has eliminated any incentive BST may have once had to misallocate or overstate its costs, which is the reason the cost assignment rules were adopted in the first place.

3. **The Commission has recently recognized the disconnection of cost assignment-derived data from price cap rate-setting.**

The Commission recently reached this conclusion in its *Wireline Broadband Order*, in which the Commission revisited the regulatory classification of broadband Internet access services offered by ILECs. Specifically, the Commission found ILEC broadband Internet access service to be an information service and concluded that ILECs

> are no longer required to separate out and offer the wireline broadband transmission component . . . of wireline broadband Internet access services as a stand-alone telecommunications service under Title II . . . . In addition, the Bell Operating Companies (BOCs) are immediately relieved of all other *Computer Inquiry* requirements with respect to wireline broadband Internet access services."[80]

In so doing the Commission additionally found that, while the wireline broadband Internet access is a nonregulated information service, *ILECs did not have to allocate any portion of the network costs to nonregulated activities* as would normally be required pursuant to Part 64. The Commission based this decision on the fact that *price cap ratemaking obviated the need for cost allocation* and further recognized the complexity and burden, with little corresponding benefit, that such allocation causes. As the Commission stated:

> Requiring that incumbent LECs classify the provision of broadband Internet access transmission provided on a non-common carrier basis as a nonregulated activity under part 64 would mean, among other matters, that incumbent LECs would have to develop, and we would have to review, methods for measuring the relative usage that this transmission and the incumbent LECs' traditional local services make of incumbent LECs' transmission facilities. *Incumbent LECs*

[80] *Wireline Broadband Order*, ¶ 5.

> *argue that they should not have to undertake this task because it would impose significant burdens on them with little discernible benefit. We agree.*[81]

The Commission further acknowledged that price cap regulation all but eliminated the need for cost allocation, especially in the light of the burdens it requires:

> During the period since the adoption of the part 64 cost allocation rules, our ratemaking methods and those of our state counterparts have evolved considerably. This evolution has greatly reduced incumbent LECs' incentives to overstate the costs of their tariffed telecommunications services. *Based on the current record, we find that this reduction in incentives diminishes the need for incumbent LECs to apply detailed and burdensome procedures to exclude the costs of providing broadband Internet access transmission from their regulated costs. A nonregulated classification therefore would generate at most marginal benefits.*
>
> *Requiring that incumbent LECs classify their non-common carrier, broadband Internet access transmission activities as nonregulated activities under part 64 would impose significant burdens that outweigh these potential benefits.*[82]

The salient regulatory principle that the Commission embraced in the broadband Internet access services context applies equally to all services provided by price cap regulated carriers such as BST. As the Commission concluded, the cost assignment rules provide no real benefit when price caps are in place, since they are not necessary to determine whether rates are just and reasonable – a conclusion that does not and should not depend on the service being provided.[83]

B. <u>The Cost Assignment Rules Are Unnecessary To Protect Consumers.</u>

There is no consumer, or general public interest protected or advanced by virtue of BST's continued compliance with the Commission's cost assignment rules. Although various theories

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[81] *Id.* ¶ 131 (emphasis added).

[82] *Id.* ¶ 133-34 (emphasis added).

[83] Furthermore, given the operational burdens imposed by the cost assignment rules – burdens that go well beyond accounting for wireline broadband Internet access service – the Commission should forbear from requiring continued compliance with such rules.

have been advanced over the years in an attempt to justify the continued application of those rules, none has merit in a situation where a carrier is subject to price cap regulation.

1. <u>**The cost assignment rules are not necessary for the fulfillment of the Commission's Universal Service obligations.**</u>

It has been argued that the Commission's cost assignment rules are needed for the calculation of universal service support governed by Section 254 of the 1996 Act.[84] This argument is misguided.[85]

Section 254(k) prohibits a carrier from using services that are not competitive to subsidize services that are competitive. Additionally, it requires the Commission, through the establishment of any *necessary* cost allocation rules, accounting safeguards, and guidelines, to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.[86] The rules from which BST seeks forbearance do nothing to ensure that the objectives of Section 254(k) are met.

As discussed extensively above, no matter what constitutes BST's "regulated" costs, BST's prices are regulated by price caps that do not take those costs into account. Price caps, in fact, were implemented to ensure that a carrier could not increase prices for services subject to price caps to offset prices for services not subject to those caps. As such, in adopting price cap regulation, the Commission has already satisfied its obligations under Section 254.

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[84] 47 U.S.C. § 254; *see 2000 Biennial Regulatory Review, supra*, at ¶ 11.

[85] *See Wireline Broadband Order*, ¶ 139 ("[The Commission's] actions [eliminating allocation of cost to non-regulated for broadband Internet access services,] in this Order . . . do not create a violation of section 254(k)").

[86] The Commission codified this section in Part 64: "A telecommunications carrier may not use services that are not competitive to subsidize services subject to competition. Services included in the definition of universal service shall bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." 47 C.F.R. § 64.901(c).

Moreover, the Commission's current mechanism for determining fund contributions is based on *interstate end-user revenues, not carrier costs*.[87] As discussed, price cap carriers' prices – and resulting revenues – are also not regulated based on costs. Because a carrier's revenues are based on the prices charged to customers -- not on the assignment of costs under the Commission's rules -- forbearance from such rules will not affect USF contributions. Similarly, high cost distributions from the USF will not be impacted by forbearance as they are based on a *hypothetical* cost model -- not the kind of embedded carrier cost structure contained in Parts 32 or 64. Accordingly, the cost assignment rules are simply not *necessary* in this context.

Finally, any allocation required under section 254(k) (even though it is no longer needed for universal service) is not limited to only ILECs but is applicable to all carriers. The Commission cannot and should not satisfy this obligation by continuing to apply rules that govern only a handful of carriers to which the vast majority of carriers competing in the marketplace are not subject.

2. <u>The cost assignment rules do not guard against price squeezes.</u>

Some have argued that, without the Commission's cost assignment rules, BST would be able to charge lower prices for competitive services by misallocating costs and thereby engage in an anticompetitive price squeeze.[88] This argument is wrong.

First, as the Commission recognized in the *Joint Cost Order*, the cost allocation and affiliate transaction rules were not implemented to protect against a price squeeze. Indeed, the Commission stated:

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[87] BST will continue to follow Part 32 revenue account classifications which separately identify intrastate and interstate revenue.

[88] *See generally* Recommendation by Joint Conference, WC Docket No. 02-269, at 23 (Oct. 9, 2003); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269, at 15-16 (filed Jan. 29, 2004).

> we disagree with those parties who intimate that we should design these rules so as to cause the accounting system to produce information that would allow us to determine whether prices for nonregulated products and services are anti-competitively low. *The pricing of individual nonregulated products and services does not fall within our statutory mandate.* Complaints about predatory pricing in nonregulated markets are the province of the antitrust laws. The proper purpose of our cost allocation rules is to make sure that all of the costs of nonregulated activities are removed from the rate base and allowable expenses for interstate regulated services. It is not our purpose, nor should it be our purpose, to seek to attribute costs to particular nonregulated activities for purposes of establishing a relationship between cost and price.[89]

Second, a price squeeze (*e.g.*, for a particular service) generally occurs when a "wholesale supplier, who also sells at retail, charges such high rates to its wholesale customers that they cannot compete with the supplier's retail rates."[90] A key issue in the price squeeze analysis is whether the relationship between wholesale and retail rates is responsible for the price squeeze.[91] The wholesale supplier's costs (*i.e.*, BST's costs) are irrelevant to this analysis.[92]

Third, a firm will engage in a price squeeze on the theory that it will be able to recoup profits lost in the short-term through the ability to charge monopoly profits after its competitors

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[89] *Joint Cost Order*, 2 FCC Rcd at 1304, ¶ 40 (emphasis added).

[90] *Joint Application by SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a/ Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, CC Docket No. 00-217, Order on Remand, 18 FCC Rcd 24474, 24477 ¶ 7 (2003) (citing *Ellwood City v. FERC*, 731 F.2d at 959, n.15 (D.C. Cir. 1984) (internal citations omitted) ("*Kansas/Oklahoma Remand Order*").

[91] *Id.* (citing *InfoNXX, Inc. v. New York Tel. Co.*, 13 FCC Rcd 3589, 3600 ¶ 21 (1997)).

[92] *See, e.g., Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., for Authorization to Provide In-Region, InterLATA Services in Massachusetts*, CC Docket No. 01-9, *Order on Remand,* 19 FCC Rcd 2839, 2845, ¶ 14 (2004) (finding "materially insufficient" AT&T's and MCI's price squeeze allegations for Massachusetts, in part, because they failed to "provide cost or other data to support their assertions regarding their $ 10 internal cost of entry" and because their "assertions that they cannot achieve a sufficient profit margin in Massachusetts are undercut by the fact that both have entered the Massachusetts residential market ...").

have been driven from the market.[93] This "price squeeze" theory makes no sense in a market as competitive as the telecommunications market, as described in greater detail below.

Finally, the Communications Act's general provisions designed to guard against anticompetitive behavior are sufficient to protect against any alleged price squeezes. These provisions include the Commission's authority to suspend or reject tariffs prior to their taking effect and to take enforcement action against unlawful pricing, including, where appropriate, granting injunctive relief and awarding of damages to the complainant in a complaint proceeding. Such provisions do not require continued adherence to the Commission's cost assignment rules in order to function properly.[94]

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[93] Declaration of William E. Taylor, Timothy J. Tardiff, and Harold Ware, National Economic Research Associates, Inc., On Behalf of BellSouth, SBC, and Verizon, WC Docket No. 02-112, CC Docket Nos. 00-175, 01-337 & 02-33, at 14 (filed Aug. 10, 2004).

[94] *In re: Petition for Waiver of Pricing Flexibility Rules for Fast Packet Services; Petition for Forbearance Under 47 U.S.C. Section 160(c) from Pricing Flexibility Rules for Fast Packet Services*, Memorandum Opinion and Order, WC Docket No. 04-246 (Oct. 14, 2005), the Commission waived certain requirements under its price cap rules and regulations to allow Verizon to exercise pricing flexibility for advanced services that rely on packet technology similar to the pricing flexibility that it has for other special access services. In so doing, the Commission rejected AT&T's claim that the grant of a waiver could result in discriminatory pricing by Verizon that is anticompetitive and causes a "price squeeze." *Id.* According to the Commission, such "price squeeze" issues should be addressed in its *Special Access NPRM,* 20 FCC Rcd 1994, since such issues required extensive "marketplace data." Furthermore, the Commission noted that a price squeeze allegation "poses a fact-intensive, highly contentious allegation that turns on economic analysis," but which AT&T had offered "no significant data or analysis to support ...." *Id.* The Commission's reasoning applies equally here; broad, unsupported allegations of purported price squeezes in the absence of the Commission's cost assignment rules do not give rise to a public interest finding sufficient to deny BST's Petition.

3. **The cost assignment rules are not necessary to determine rates for unbundled network elements.**

In past Commission proceedings, some parties have contended that the cost assignment rules should be maintained because they support some of the cost models used to determine the forward-looking costs of unbundled network elements.[95]

This contention is wholly unpersuasive because unbundled network element costs represent the *forward-looking economic cost* of a particular element of the telecommunications network -- not the embedded historical costs of that facility or the cost of different services that are provided utilizing those network elements. In this regard, the TELRIC methodology focuses on determining the forwarding-looking cost of providing an element of the network, such as an unbundled loop, to a competitive local exchange carrier ("CLEC"). By contrast, the purpose of the Commission's cost assignment rules is to address historical embedded costs and investment – a purpose fundamentally misaligned with the objective of unbundled network element cost studies.

Furthermore, even though current TELRIC cost models may utilize certain factor relationships developed from historical regulated results to anticipate similar cost relationships in calculating forward-looking cost, this does not mean that the Commission's cost assignment rules are necessary for TELRIC cost studies. One example of such a factor relationship is the specific expense for aerial metallic cable plant as it is relates to aerial metallic cable investment. Whereas Part 64 rules would look to the type of traffic usage that is transmitted over the cable in

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[95] *See, e .g.*, Comments of the National Association of State Utility Consumer Advocates ("NASUCA"), WC Docket No. 02-269, at 6 (filed Jan. 30, 2004); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269, at 6-7 (filed Jan. 29, 2004); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269, at 6 (filed Jan. 30, 2003); Comments of AT&T Corp., WC Docket No. 02-269, at 13-14 (filed Jan. 31, 2003).

order to allocate costs between regulated and nonregulated services, the information that is desired for TELRIC purposes is how much plant specific-type expense is required – on a forward-looking basis -- to maintain aerial metallic cable *regardless of the type of traffic usage on the cable.*

4. **The cost assignment rules are not necessary to allow regulators to perform their monitoring and oversight responsibilities.**

In the Joint Conference proceeding, several state public service commissions argued that, even with price cap regulation, regulators continue to need regulatory accounting and reporting in order to monitor carriers and perform oversight responsibilities.[96] This argument, even assuming it were correct, does not impact the merits of this Petition because BST is not seeking forbearance from any of the Commission's rules regarding Part 32 *accounts* identified as a key state commission concern. If BST's Petition is granted, the Part 32 accounts will remain intact and all relevant ARMIS reports will continue to be produced.

The concerns voiced in the Joint Conference proceeding mainly focused on the Part 32 accounts and whether some accounts, which the Commission had eliminated in its *Phase 2 Order*, should be reinstated and whether some new accounts should be created. The Joint Conference issued a recommendation to the Commission, which addressed these issues specifically. For example, in the *Joint Conference Order*,[97] the Commission decided, based

[96] *See, e.g.*, Comments of the North Carolina Utilities Commission – Public Staff, WC Docket No. 02-269 (filed Jan. 31, 2003); Comments of the Florida Public Service Commission Regarding Accounting Issues, WC Docket No. 02-269 (filed Jan. 29, 2003); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269 (filed Jan. 30, 2003).

[97] *Federal-State Joint Conference on Accounting Issues; 2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, WC Docket No. 02-269; CC Docket Nos. 00-199, 80-286 & 99-301, *Report and Order*, 19 FCC Rcd 11732 (2004).

upon the recommendation of the Joint Conference, to reinstate several accounts it had previously consolidated.[98] Nothing in BST's Petition would affect those accounts; they would remain in Part 32, and BST would continue to record those accounts as it does today.

The Joint Conference Report also made recommendations regarding affiliate transactions, claiming that continued monitoring of such transactions was necessary in order to deter "anticompetitive manipulation of costs, revenues, and earnings."[99] It went on to refer to the need to avoid "accounting scandals," such as those involving Enron and WorldCom.

However, the accounting scandals addressed in the Joint Conference are not in any way related to the Commission's affiliate transaction rules. The affiliate transaction rules were put in place to prevent cross-subsidization of nonregulated services by regulated services under rate-of-return regulation. These rules have nothing to do with, and cannot ensure the financial integrity of, a publicly traded company, nor do they address the type of fraud and abuse in which both Enron and WorldCom routinely engaged (which, as discussed herein, has been addressed by Sarbanes-Oxley, among other things).

Furthermore, the "evil" that the affiliate transaction rules were put in place to guard against – cross-subsidization between regulated and nonregulated services -- is no longer a valid concern. Under price cap regulation, the allocation of costs associated with affiliate transactions has no bearing on the regulation of rates. For tariff filings involving price changes of existing services under price cap regulation, the ILEC must provide (as a part of its tariff filing) a

[98] The *Phase 2 Order* consolidated account number 5230, directory assistance, into account number 5200, miscellaneous. It also consolidated account numbers 6621, call completion services, 6622, number services, and 6623, customer services into a single account – account number 6620. Finally, it consolidated four depreciation and amortization expense accounts, account numbers 6561, 6562, 6563, 6565 into one single depreciation and amortization expense account – account number 6560.

[99] *Id.*

demonstration that the price change is within the applicable price cap basket service band index limits and that the basket price cap index remains below the applicable basket actual price index after the price change.

Affiliate transactions are recorded on the books of the regulated telephone company in a multitude of accounts. These accounts, however, are never incorporated directly or indirectly into the formulas used to govern rates under price cap regulation. A change in the value of affiliate transactions recorded in the cost accounts will not, and cannot, have an impact on the prices resulting from the application of the price cap rules to existing services. In addition, the price cap baskets were originally designed to group similar or like services together, while at the same time preventing service prices in one particular basket from subsidizing the (lower) prices in another price cap basket. Thus, neither the Commission's affiliate transaction rules nor its other cost assignment rules are necessary to protect consumers and, thus, cannot be shown to be "strongly connected" to that goal.

C. Forbearance From The Commission's Cost Assignment Rules Is Consistent With The Public Interest.

1. The rules represent antiquated regulatory barriers that now must be broken down.

The rules at issue are not strongly connected – or connected at all – to rates. They are not strongly connected – or connected at all – to the consumer protection goals for which they were designed. The only possible remaining claim for their continued viability in BST's case is if, somehow, the rules add value to the products and services that today's consumers demand. They most assuredly do not.

Consumers in every market segment want the widest range, and broadest integration, of communications and information services that can be delivered.

Technological advancements make it possible to serve these demands. As the Commission itself observed:

> Reflecting these advances, manufacturers have developed powerful platforms that integrate traditionally separate computing and communications functions. * * * The technology used to build networks, and the purposes for which they are built, are fundamentally changing, and will likely continue to do so for the foreseeable future. . . . Network platforms therefore will be multi-purpose in nature and more application-based, rather than existing for a single, unitary technologically specific purpose.[100]

The cost assignment rules were developed and implemented in a technological era in which networks *did* exist "for a single, unitary technologically-specific purpose." Phone networks provided phone service. Computer networks provided computing service. The "twain did not meet." Now they do, and the range of possibilities is staggering. Rate-of-return era cost assignment rules could not be more ill-suited to the complex, integrated, network platforms that power the integrated products and services that BST provides, and that its customers demand. If it had it to do today, the Commission, one must assume, certainly would not re-create the rules in present form.

Complying with the rules presents a stiff (and undue) challenge to BST in today's integrated communications and information marketplace. The complexity of the allocations and separations decisions that the assignment rules compel has grown weed-like in the development and delivery of the products and services that consumers want. As shown in the IDSU (network asset) and advertising discussions above, the rules present time-consuming, resource-intensive "chokepoints" that slow the process of getting innovative, integrated services to customers. Customers do not want to wait --

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[100] *Wireline Broadband Order, supra,* at ¶¶ 35-41.

and, indeed, often cannot afford to wait – for BST to determine how to allocate costs associated with services and products.

When customers cannot get what they need in a time frame that competitive market conditions warrant, they have two choices: go elsewhere, or do without. Neither outcome serves the public interest. First, customers should not have to wait for compliance with rules-driven activity *that no longer has any bearing on the rates it charges customers and no longer serves any of the consumer protection ends originally contemplated.* Customers are served by having a variety of high-quality choices for their communications and information needs. Limiting BST's capacity to present such a choice to customers diminishes customers' prospects for no valid reason.

Second, if the customer has to forego the product or service, or has to settle for something with less functionality than BST could have provided if it had been able to deliver in timely fashion, everyone loses. Customers use BST's products and services, often enough, to enhance their own abilities to compete in the markets in which they operate, or the environments in which they live. Government customers administer to citizens based on services provided by BST. Students are educated to compete in today's global marketplace using BST's services and products. Businesses employ services and products provided by BST to enhance their domestic, and international, competitiveness. The list goes on and on.

Common to all of these consumer endeavors is the need for constantly evolving, integrated services and products -- and *fast*. BST embraces the challenge of meeting the scope of its customers' demands. But, BST must be allowed *to meet the pace of those demands as well.* Compliance with the cost assignment rules unquestionably slows BST down and, as demonstrated, there is simply no justification for it. It is certainly "consistent with the public interest," thus, for the Commission to "break down" the "rigid regulatory barriers" that the rules present to BST's ability dynamically to serve its customers.

2. **Granting the Petition is in the public interest because BellSouth will remain subject to all financial accounting requirements applicable to public companies.**

Granting BST's Petition will not result in a lessening of necessary protections for consumers or the public at large. To the contrary, BellSouth is, and will remain, subject to and governed by all financial accounting requirements applicable to publicly traded companies. BellSouth, like all other public companies, is subject to the jurisdiction and regulations of the Securities and Exchange Commission ("SEC"). As such, it must maintain books and accounts and prepare financial reports that conform to Generally Accepted Accounting Principles ("GAAP"), which are the accounting standards employed by publicly traded companies to determine and report their financial condition to the public. This information must be audited by an independent public accounting firm and publicly disclosed.

BST understands that, in the wake of recent high-profile accounting scandals involving large, publicly-traded companies such as Enron and WorldCom, the Commission may be concerned about a perceived lessening of accounting obligations for a carrier under its jurisdiction. BST does not take those concerns lightly. However, the Commission should be assured that this Petition does not involve or even impact any accounting rule or regulation, whether established by this Commission or any other regulatory authority, that is designed to protect the public from corporate malfeasance and to ensure accurate reporting of a company's financial health.

This Petition, if granted, would not eliminate any accounting requirement or regulation established by, or within the jurisdiction of, the SEC or any other agency regarding the proper recording of revenues, expenses, investment, or debt in financial statements. To demonstrate the types of controls under which BellSouth will remain if BST's Petition is granted, the independent accounting firm of Deloitte & Touche ("D&T") prepared a detailed analysis of the financial accounting and reporting rules and disclosures applicable to all public companies, such as BellSouth.[101] This analysis should give the Commission comfort that this Petition, if granted, will not diminish public protection.

As D&T discusses, public companies like BellSouth are subject to many layers of financial oversight through federal and state regulations and statutes. BellSouth is and will remain subject to the jurisdiction of the SEC, an agency that was created to "protect investors and maintain the integrity of the securities market."[102] The federal laws that the SEC administers "seek to ensure that the securities markets are fair and honest."[103] It ensures compliance through extensive periodic reporting requirements, which include an annual Form 10-K and three quarterly reports through Form 10-Q. These reports include financial information that is governed by Regulation S-X and non-financial information governed by Regulation S-K. The financial statements included in the reports filed with the SEC are required to have annual audits and interim reviews performed by independent auditors.[104]

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[101] Donna Epps, Deloitte & Touche LLP, *Reporting after Reform: Financial Accounting Rules and Disclosures in Reporting by U.S. Public Companies* (2005) ("D&T Paper") (attached as Appendix 8.

[102] *Id.* at page 19, Appendix A: SEC.

[103] *Id.*

[104] *Id.* at page 15.

In addition to the reporting requirements, the SEC has oversight responsibilities through monitoring and enforcement. Monitoring includes review of the Forms 10-K and 10-Q at least once every three years.[105] The SEC's enforcement division has civil as well as criminal authority over violations of any securities laws. Such violations include, but are not limited to, misrepresentation or omissions of important information from filed documents, and the mis-use of non-public information.[106]

Recent federal law developments have enhanced the SEC's (and other agencies') pre-existing regulatory, oversight and enforcement authority. The result of these developments is even greater protection to the public and investors from accounting abuses. The most significant of these new laws is the Sarbanes-Oxley Act, a major corporate accountability reform measure that imposes significant new disclosure requirements on all public companies.[107] Specifically, Sarbanes-Oxley makes a company's officers personally responsible for the company's financial statements and strengthens the audit requirements by expanding the scope of work that an auditor must perform in order to provide an unqualified opinion regarding a company's financial statements. Sarbanes-Oxley also created the Public Company Accounting Oversight Board ("PCAOB") "to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports for companies the securities of which are sold to, by and for, public investors."[108]

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[105] *Id.* at page 16.

[106] *See* D&T Paper at 17.

[107] *Id.* at 5.

[108] *Id.* at page 25, Appendix C: PCAOB. (The PCAOB must "conduct regular inspections of each firm to ensure that the firm and its professional practitioners are in

The PCAOB has enforcement authority over independent auditors of public companies and may impose appropriate sanctions[109] on any auditor that is found to violate "any provision of the Sarbanes-Oxley Act, any professional standards, any rules of the PCAOB or the SEC, or any provisions of the U.S. securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto."[110] Thus, Sarbanes Oxley not only places important new controls over the public companies themselves, it also created a regulatory body to oversee the auditors that audit these companies to ensure that they maintain independence from the companies and follow appropriate professional standards.

Sarbanes-Oxley also places significant new requirements for management and independent auditors to access, document and report on the effectiveness of Internal Control over Financial Reporting ("ICFR")."[111] This change includes "new reports and certifications by management on the effectiveness of the company's ICFR." [112] The auditor also must supplement its report on a company's financial statements with management's assessment on ICFR and on the effectiveness of the company's ICFR. This strengthening of internal control not only deters fraud but also prevents inaccurate financial statements.[113] BellSouth's most recent financial statement audit included over 2,000 hours of audit work that specifically tested for Sarbanes-Oxley compliance.

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compliance with the Sarbanes-Oxley Act, PCAOB rules and standards, SEC rules and standards, as well as professional standards [*e.g.*, AICPA's]").

[109] Sanctions "may range from monetary penalties and remedial measures, such as training, new quality control procedures, or the appointment of an independent monitor, to barring the firm or individual from future audits of public companies." D&T Paper at 18.

[110] D&T Paper at 18.

[111] *Id.* at 5.

[112] *Id.*

[113] *Id.*

In past proceedings, some commenters have argued that the Commission's accounting rules should remain in place to protect against the kind of behavior seen in past accounting scandals. The Commission, of course, is not a financial regulator, and its cost assignment rules were not established to and do not protect against the kinds of abuses seen in the high-profile accounting scandals of the late 1990s. In any event, Sarbanes-Oxley amply meets the concerns that various commenters have expressed before the Commission, and should remove any reservations the Commission might otherwise have had on the subject as it considers the merits of this Petition.

The GAAP-based accounting and reporting requirements established by various federal agencies, as well as the accounting standards established under the authority of the SEC, will be unaffected by the granting of BST's Petition. The SEC relies on the FASB to establish GAAP in the United States ("U.S. GAAP") through a prescribed standard-setting process. Financial statements filed with the SEC that are not in conformity with U.S. GAAP are considered to be misleading or inaccurate, and are therefore unacceptable to the SEC.[114] GAAP establishes that a company must disclose, both in notes to its financial statements as well as in the statements themselves, exactly how it applies accounting standards.[115]

BellSouth complies with GAAP for all financial accounting reporting purposes. The Commission accepts GAAP as an appropriate means of maintaining regulatory books and the

[114] *Id.* at 3. ("The SEC is legally charged with establishing accounting policies in the United States, but relies on private the standards –setting bodies such as the Financial Accounting Standards Board ("FASB"), [the PCAOB] and the American Institute of Certified Public Accountants ("AICPA").")

[115] D&T Paper at 7.

USOA currently prescribed by the Commission is primarily based on GAAP.[116] The Commission also has ordered ILECs' regulated separate affiliates to use GAAP.[117] CLECs, cable companies, wireless carriers, and others use GAAP for all accounting and financial reporting purposes.

BellSouth is also subject to the Foreign Corrupt Practices Act ("FCPA").[118] The FCPA, among other things, requires every public company to make and keep "books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."[119] The FCPA substantially penalizes "issuers" (*i.e.*, public companies) for failing to devise and maintain proper internal controls, or for making false entries in its financial books and records.

The Sarbanes-Oxley-augmented accounting and reporting oversight provided by the various accounting regulatory agencies ensures that BellSouth's investors and potential investors receive full and accurate information about all of BellSouth's financial dealings. The rules from which BST seeks forbearance have no impact on the accounting and disclosure rules and reporting requirements that are in place to protect the investment community. Any concern that eliminating cost assignment rules will weaken accounting regulatory oversight and enforcement is an unwarranted distraction from the central issue here, which is whether the cost assignment remain necessary for the purposes for which they were developed (which is not the case)..

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[116] Because BST is required to maintain accounting records under Part 32, the ILEC's financial results are close to, but not exactly the same as, the financial results under GAAP (*e.g.*, depreciation expense is treated differently.)

[117] *Accounting Safeguards Order, supra,* 11 FCC Rcd at 17618 and 17649, ¶¶ 170, 243.

[118] 15 U.S.C. §§ 78m (b) (2), 78dd-1, 78dd-2.

[119] *Id.* at § 78m(b)(2)(A).

Lastly, in addition to the foregoing provisions applicable to public companies, BST will remain subject to the Commission's Part 32 chart of accounts, which enables the Commission to monitor BST's financial information for regulatory purposes. Thus, BST will continue to record and report information pursuant to these rules, including ARMIS reporting.[120] However, the elimination of the cost assignment rules will affect the makeup of some of the ARMIS reports because certain data would no longer be available through ARMIS. This would include ARMIS Report 495A (Forecast of Investment Usage), Report 495B (Actual Usage of Investment), and Report 43-04 (Access), which would no longer be produced.[121] Other reports that would be affected but would continue to be produced include ARMIS Report 43-01 (Annual Summary), Report 43-02 (USOA Report), and Report 43-03 (Joint Cost Report). These ARMIS Reports involve data that are no longer necessary, and would not be provided after the granting of this Petition. A summary of the impact of this Petition on ARMIS reporting is attached as Appendix 9.

In summary, it is in the public interest for BellSouth to be treated as much as possible like all other public companies for accounting purposes. There is ample federal regulatory governance over BellSouth's financial reporting and use of accounting in those reports. Further, because the Commission's role in monitoring BellSouth's financial data for regulatory purposes will be preserved *via* Part 32 and ARMIS, there remains an element of enhanced public oversight specific to the Commission. The limited forbearance requested in this Petition is clearly in the public interest.

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[120] There are two rules from which BST is seeking forbearance that are codified in Part 32. However, these rules are not part of the USOA, but relate specifically to rules that are further codified in Part 64, subpart I.

[121] In 2004, only the RBOCs provided data for these three reports. *See* http://www.fcc.gov/wcb/armis.

3. **As the market becomes more competitive, the public interest is served by jettisoning outdated accounting rules.**

The Commission previously observed that "changes in the competitive conditions of local telecommunications markets in the future may cause us to re-examine the continued need for our Part 64 cost allocation rules."[122] Similarly, in its *2000 Biennial Regulatory Review*, the Commission recognized *"that the national marketplace in which the regulated LECs operate continues to move toward a competitive model,"* and acknowledged the need to "strike an appropriate balance between the operations of the free market and a continuing need for some regulation."[123] With the current level of competition in the communications market, BST submits that the only way for the Commission to strike the "appropriate balance" about which it was rightfully concerned is by granting this Petition.

Almost a decade after the passage of the 1996 Act, communications competition is flourishing. According to the Commission's most recent report on local telephone competition, CLECs maintained 18.5% of the total end-user switched access lines nationally.[124] This translates into 32.9 million lines, which is up over 3 million lines since December 2003. CLECs achieved this increase while ILECs lost 8 million lines.

However, these statistics are misleading because the line between the local and long distance market has been nearly erased, particularly with the proliferation of wireless service. The number of wireless subscribers has grown from approximately 55 million in 1997 to more than 182 million by year end 2004, with more than 23 million new wireless subscribers being

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[122] *Accounting Safeguards Order*, 11 FCC Rcd at 17,661, ¶ 271.

[123] *2000 Biennial Regulatory Review, supra,* 16 FCC Rcd at 19,913, ¶ 2 (emphasis added)

[124] Ind. Anal. & Tech. Div., Wireline Competition Bureau, FCC, *Local Telephone Competition: Status as of December 31, 2004*, at Table 1 (July 2005). This was representative of the lines within BST's region with a range of 10% in Mississippi to 20% in Georgia.

added last year.[125] By contrast there are approximately 183 million wireline access lines, a number declining each year,[126] and it is expected that this year the number of cell phone users will exceed the number of wireline access lines.[127]

Growing numbers of wireless subscribers are abandoning their wireline service altogether. During the last few years, the percentage of wireless users that have given up wireline service has grown to 7-8 percent.[128] Approximately 3 million additional wireless subscribers are now giving up their wireline phones each year, and even larger percentages of young consumers – who will make up the next generation of homeowners – are disconnecting their wireline service altogether, which make it likely that the rate of substitution will increase even further in the future.[129]

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[125] *CTIA's Semi-Annual Wireless Industry Survey Results, available at* http://files.ctia.org/pdf/CTIAYearEnd2004Survey.pdf.

[126] *See, e.g.*, Ind. Anal. & Tech. Div., Wireline Competition Bureau, FCC, *Trends in Telephone Service,* at Table 7.1 (June 2005) (end-user switched access lines have declined steadily since their peak in 2000).

[127] Adam Quinton, Managing Director & First Vice President, Co-Head of Global Telecom Services Research, Merrill Lynch, prepared witness testimony before the Subcommittee on Telecommunications and the Internet of the House Energy and Commerce Committee, Washington, DC (Feb. 4, 2004).

[128] *Id; see also* Michael Balhoff, Managing Director, Telecommunications Group, Legg Mason, prepared witness testimony before the Subcommittee on Telecommunications and the Internet of the House Energy and Commerce Committee, Washington, DC (Feb. 4, 2004).

[129] B. Bath, Lehman Brothers, *Final UNE-P Rules Positive for RBOCs* at Figure 2 (Dec. 10, 2004).A. Quinton, *et al.*, Merrill Lynch, *Telecom Services: Unraveling Revenues* at 5 (Nov. 20, 2003) ("[W]e believe that demographic trends favor wireless. . . . So, as the US population ages, more young people are likely to become wireless subscribers – and either displace the purchase of a wireline service with wireless or cut the cord on an existing line."); S. Ellison, IDC, *U.S. Wireline Displacement of Wireline Access Lines Forecast and Analysis, 2003-2007* at 7 (Aug. 2003) ("The first communications services purchased by youth and young adults are now often wireless services. Adoption of wireless by teenagers is increasingly being translated into forgoing traditional primary access lines when such wireless users go to college or otherwise establish their own households.").

In addition to replacing the landline phone as the primary means of making local calls, wireless carriers are competing aggressively to displace long distance telephone calls that previously were made on wireline networks. Wireless service packages include unlimited long distance calling, which has contributed to wireline traffic substitution and increasing average minutes of use among wireless carriers. As one analyst explained, "[t]hanks to unlimited night and weekend minutes ... cellphone plans are the method of choice when it comes to long-distance calling from home."[130]

With the increase in wireless subscribers and the variety of competitive packages being offered by wireless carriers, greater amounts of traffic are migrating from wireline to wireless networks. According to industry reports, wireless minutes of use exceeded one trillion in 2004,[131] and analysts estimated that in 2004 "wireless could make up approximately 29% of voice minutes in the US."[132] Wireless voice minutes are rising at 36 percent per year,[133] while minutes on landline networks have declined.[134] The increase in wireless long-distance calls is

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[130] W. Mossberg, *The Mossberg Solution: Turning Your Home Phone into a Cellphone – Call-Forwarding Devices Let You Use Cellular Service on a Traditional Phone*, Wall St. J. at D6 (Dec. 3, 2003).

[131] *CTIA's Semi-Annual Wireless Industry Survey Results, available at* http://files.ctia.org/pdf/CTIAYearEnd2004Survey.pdf.

[132] D. Janazzo, *et al.*, Merrill Lynch, *The Next Generation VIII: The Final Frontier?* at 5 (Mar. 15, 2004); *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993*, WT Docket No. 02-379, *Eighth Report*, 18 FCC Rcd 14783, 14929, ¶ 102 (2003) ("One analyst estimates that wireless has now displaced about 30 percent of total wireline minutes.").

[133] Adam Quinton, Managing Director & First Vice President, Co-Head of Global Telecom Services Research, Merrill Lynch, prepared witness testimony before the Subcommittee on Telecommunications and the Internet of the House Energy and Commerce Committee, Washington, D.C. (Feb. 4, 2004).

[134] *See, e.g.*, Ind. Anal. & Tech. Div., Wireline Competition Bureau, FCC, *Trends in Telephone Service* at Table 10.1 (Aug. 2003); S. Flannery, *et al.*, Morgan Stanley, *Telecom Services: Trend Tracker: Spring Break! Some Temporary Telecom Relief* at 23 (Mar. 18, 2004).

even greater as estimates are that wireless subscribers make 60 percent of their long-distance calls on their wireless phones.[135]

In addition to wireless substitution, there also is increased competition from cable operators and VoIP providers. According to analysts, "Cable telephony, circuit and packet, represent about 3.4 million households today or 3%, but we see this rising steadily to about 17.2 million or 15% by 2010."[136] The number of consumers subscribing to VoIP has been forecast to grow from 1.1 million in 2004 to 28.5 million by 2009.[137] The Commission has acknowledged that consumers of VoIP service expect it to function as a "regular telephone" service,[138] which means that it increasingly competes with traditional telephone services.

As competitive alternatives continue to expand, a constant factor has been the willingness of the Commission to allow competition to develop without the hindrance of unnecessary regulation.[139] The Commission has the opportunity to do precisely that by granting BST's Petition to forbear from cost assignment rules that no longer serve any legitimate purpose.

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[135] P. Marshall, *et al.*, The Yankee Group, *Divergent Approach to Fixed/Mobile Convergence* at 7 & Exh. 4 (Nov. 2004).

[136] Banc of America Securities Research Brief, *Setting the Bar: Establishing a Baseline for Bell Consumer Market Share* (June 14, 2005).

[137] Yankee Group, *Consumer Market for US Residential VoIP Services Accelerates* (June 28, 2005).

[138] *See generally IP-Enabled Services; E911 Requirements for IP-Enabled Service Providers,* WC Docket Nos. 04-36 & 05-196, First Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 10245 (2005).

[139] *See, e.g.*, *Pricing Flexibility Order*, 14 FCC Rcd at 14224, ¶ 1 ("[W]e continue the process [of reforming] regulation of interstate access charges in order to accelerate the development of competition in all telecommunications markets and to ensure that our own regulations do not unduly interfere with the operation of these markets as competition develops."); *Wireline Broadband Order*, ¶¶ 3, 5 ("Today, we decide that the appropriate framework for Wireline broadband Internet access service . . . is one that is eligible for a lighter regulatory touch[,] . . . in light of the competitive and technical characteristics of the broadband Internet access market today . . . .").

4. Granting the Petition promotes competition.

Section 160 provides that, in making its public interest determination, the Commission shall consider whether forbearance from enforcing the provision or regulation will promote competitive market conditions, including the extent to which such forbearance will enhance competition among providers of telecommunications services. If the Commission determines that such forbearance will promote competition among service providers, that determination may support a Commission finding that forbearance is in the public interest.[140]

The activities involved in rules compliance do not support ratemaking, wherein the public interest, in this context, would most closely be identified. Thus, the value of continued rules enforcement is less than zero from a public interest perspective. The public interest, however, *is* clearly aligned with the presence of robust competition by providers of telecommunications products and services. Each competitor should be free to deploy its resources, to the maximum extent possible, toward positive activities that generate consumer benefit. A significant portion of BST's resources, as described herein, are deployed in rules-mandated activities that do not produce value to consumers. This ties BST's competitive hands in ways that no longer can be justified.

VI. CONCLUSION

For the foregoing reasons, the Commission should grant BST's Petition seeking forbearance from the Commission's cost assignment rules. BST's Petition satisfies the forbearance criteria because: (1) no "strong connection" exists between continued enforcement and application of the Commission's cost assignment rules and the Commission's statutory goal of ensuring that BST's rates are just, reasonable, and nondiscriminatory; (2) no "strong connection" exists between continued enforcement and application of the Commission's cost

[140] 47 U.S.C. §160(b).

assignment rules and the Commission's statutory goal of protecting consumers in this context; and (3) granting BST forbearance from these antiquated rules is in the public interest. As such, the Commission must grant the forbearance sought. *See* 47 U.S.C. §§ 160 (a) and (c).

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